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No. 05-

IN THE

Supreme Court of the United States

JOHN KILGOUR LENTELL,

Petitioner,

v.

MERRILL LYNCH & CO. and HENRY M. BLODGET,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

I. Has a plaintiff in a securities fraud class action adequately pled loss causation by alleging both (1) purchase of the stock at a price artificially inflated by fraudulent securities analyst recommendations, and (2) economic loss when the artificial inflation is removed from the stock's price by foreseeable operation of the market forces of supply and demand prior to an explicit disclosure of the fraud?

II. Where the Court of Appeals announced a new and more stringent standard for pleading loss causation, was it a denial of due process not to permit an opportunity to amend the pleadings to meet the new standard?

PARTIES TO THE PROCEEDING

Petitioner is John Kilgour Lentell

Respondents are Merrill Lynch & Co. Inc. and Henry M. Blodget

Brett Raynes and Juliet Raynes were appellants in the United States Court of Appeals for the Second Circuit but are not parties to this Petition.

Petitioner John Kilgour Lentell is lead plaintiff in a putative class action brought on behalf of investors in 24/7 Real Media, Inc against Respondents. Brett and Juliet Raynes were lead plaintiffs in a putative class action brought on behalf of investors in Interliant, Inc. against Respondents. The two cases were consolidated for appeal in the United States Court of Appeals for the Second Circuit. Brett and Juliet Rayes are not seeking review of the Second Circuit's Opinion before this Court and are accordingly not parties to this Petition. The present petition is thus filed solely on behalf of Lentell.

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The opinion of the Court of Appeals (Pet. App. 1a–32a) is reported at 396 F.3d 161 (2d Cir. 2005). The District Court's opinion (Pet. App. 64a-126a) is reported at 273 F. Supp. 2d 351 (S.D.N.Y. 2003).

STATEMENT OF JURISDICTION

The Court of Appeals entered its judgment on January 20, 2005, and a petition for *en banc* review was denied on March 31, 2005. Pet. App. 127a-128a. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTES AND CONSTITUTIONAL PROVISION INVOLVED

The relevant provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78a, *et seq.*, including the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), P.L. 104-67, 1995 HR 1058, involved are:

15 U.S.C. § 78u-4

(b) Requirements for securities fraud actions.

* * *

(4) Loss causation.

In any private action arising under this title, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages.

The relevant constitutional provision involved is:

U.S. Const. Am. V

> No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a grand jury, except in cases arising in the land or naval forces, or in the militia, when in actual service in time of war or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

STATEMENT OF THE CASE

This is a securities fraud class action brought on behalf of purchasers of common stock in 24/7 Real Media, Inc. ("24/7"). Petitioner's complaint was dismissed in the District Court for, *inter alia*, failing to allege "loss causation" within the meaning of the federal securities laws. Pet. App. 64a – 126a. That dismissal was affirmed by the Second Circuit. Pet. App. 1a – 32a. This opinion created a circuit split. *See* Section I, *infra* pp. 13-23.

The complaint alleged that Respondents (who, among other roles, were respected and influential securities analysts)

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1. The 24/7 Class Period extended from May 12, 1999 to November 9, 2000. The 24/7 class action was one of two separate putative class actions brought on behalf of investors in Merrill-recommended stocks which were consolidated for appeal. (the other was on behalf of purchasers of Interliant, Inc. common stock. *See In re Merrill Lynch & Co., Inc. Interliant, Inc. Research Reports Securities Litigation*, No. 02-CV-3321(MP) (S.D.N.Y.)). Only the Lentell (24/7) lead plaintiffs are in filing this petition; the Interliant plaintiffs are not parties to this petition.

issued a number of materially misleading positive analyst reports and buy recommendations on a number of Internet stocks to attract lucrative investment banking business for themselves. The falsely positive reports induced artificial excess demand for the stocks and thus artificially inflated the prices of the stocks.

Respondents maintained this artificial inflation as long as possible by successively recommending purchase of the stocks at ever-increasing prices and predicting future appreciation to even higher price targets; in doing so, Respondents fueled a market frenzy for the stocks and induced more purchase demand at higher prices than would have existed in a market untainted by the fraudulent research reports.

Petitioner's loss causation theory is that over time, Respondents' ability to maintain the artificial inflation waned as the market gradually realized the disconnect between the research recommendations and the true values of the stocks, and as it became increasingly more difficult to generate sufficient additional purchase demand by means of repetitive fraudulent buy recommendations. The inevitable, subsequent market correction caused a collapse in the market prices of the stocks, which lost the majority of their market values before Respondents finally and belatedly downgraded their research ratings and well before the fraudulent nature of the original buy recommendations was publicly revealed.

In essence, the analyst fraud created an undisclosed investment risk that purchasers would suffer substantial losses when the inevitable market correction eventually occurred. The materialization of this risk – concealed at all relevant times by Respondents – was the ultimate cause of the investors' losses. By their false and misleading buy recommendations, Respondents had set in motion an engine that ineluctably, through a chain of foreseeable, connected events, led to the losses.

This Court has recently held that an allegation of "purchase price inflation ***alone***" is insufficient to plead loss causation. *Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627, 1630 (2005) (emphasis added). However, Petitioner's theory is that the particular kind of price inflationary scheme employed, involving fraudulent buy recommendations by influential market analysts to induce excess, artificial demand, as opposed to a scheme of false or misleading statements of fact about a company's business or operations, contains within itself the seeds of inevitable market correction and loss.

Where a stock price is allegedly inflated by a factual misrepresentation inflating a company's earnings, for example, presumably the price inflation remains embedded in the stock price until the earnings inflation is corrected by a public disclosure of the true, lower earnings. The artificial price inflation of the kind engendered by analyst fraud, however, does not presumably remain imbedded in the price until disclosure of the fraud but often is weeded out of the price over time by the natural operation of supply and demand as the performance of the stock fails to live up to the analyst recommendations. The market correction itself takes the place of a corrective disclosure in revealing the falsity of the analyst recommendations (even though it may not reveal that the recommendations were published with fraudulent intent).

In these circumstances, a plaintiff has adequately pled that the economic loss was proximately caused by the analyst fraud even though the decline in stock price was not triggered by, but pre-dated, a corrective disclosure of the fraud.

A. Factual Background

1. Conflicts of Interest Within Merrill Lynch Gave Rise to Fraudulent Conduct

Respondents here are (1) Merrill Lynch & Co. ("Merrill") a financial service company and (2) Henry Blodget ("Blodget"), a former "star" analyst for that company. Merrill provides two services relevant to this petition.

First, as an investment bank, Merrill claims to be a leading global underwriter of debt and equity securities. Second, through its Global Securities Research & Economics Group, Merrill claims to rank among the leading research providers in the securities industry and, in that capacity, issues periodic reports purportedly detailing objective research and analysis of various securities.

The performance of these two functions creates an inherent conflict of interest, insofar as promoting Merrill's investment banking business requires currying the favor of securities issuers, whereas producing objective reports necessitates maintaining independence from those same issuers. The risk created by this conflict is that investment bankers could influence analysts' ratings for the stock of existing or potential investment banking clients. Unsurprisingly, this risk is exacerbated when an analyst's monetary compensation is affected, directly or indirectly, by the analysts' contribution to investment banking business.

Typically, securities firms eliminate this risk by establishing so-called "Chinese Walls" between investment banking and research, which restrict and monitor the flow of information between the two divisions. While Merrill claimed to have implemented such a protective measure, this representation was false.

In fact, Merrill's business was characterized by undisclosed material conflicts of interest, including secret agreements between the Analysts and the Investment Bankers to "trade" favorable, bullish analyst reports for investment banking business directed to Merrill and secret sharing of investment banking fees among Merrill Lynch and its Internet analysts.

Throughout the Class Period, the Internet Group never issued a single report which included a "Reduce" or "Sell" recommendation or rating – ***even when contemporaneous e-mails show that they personally believed the stock would decline.*** Respondents concealed from the investing public this policy and practice, because rating any Internet stock lower than "Accumulate" would jeopardize efforts to obtain investment banking business from that company.

Thus, Merrill issued analyst reports containing positive investment recommendations that did not reflect the true opinions of the analysts and which concealed the lack of any rational basis underpinning the recommendations contained in those reports. As Merrill and Blodget were widely respected and influential analysts, these reports had the effect of inflating the stock prices above those which would otherwise have prevailed. The artificially inflated prices eventually collapsed and fell to a fraction of their peak inflated values.

The eventual price collapse resulted from two factors. First, as the market gradually came to realize the falsity of the recommendations, the ability of Merrill to continue to generate high levels of buying demand declined and the prices correspondingly fell. As one court put it, "[a]s the gap between rating and reality widen[ed], however, the analyst's ratings gradually [lost] credibility and the market value[d] them less and less." *Swack v. Credit Suisse First Boston*, No. 02-11943-DPW, 2004 U.S. Dist. LEXIS 22749 at *14 (D. Mass. 2004). Second, when Merrill belatedly downgraded its ratings and recommendations, the stock prices declined even further.

2. The Fraudulent Conduct Caused Losses to Investors in 24/7

Respondents' research coverage of 24/7 Real Media, Inc., is a paradigmatic example of the operation of the scheme outlined above.

Merrill served as lead underwriter for 24/7's August 14, 1998 initial public offering, earning at least $1.47 million in underwriting fees. In September 1998 (soon after the IPO), Merrill initiated coverage on 24/7 with an "Accumulate/Buy" recommendation.

On April 27, 1999, 24/7 issued additional common stock through a Secondary Offering of 3.5 million shares priced at $46.00 per share. Merrill, again, served as lead underwriter and earned another $1.77 million in underwriter fees. Two weeks later, 24/7 stock was trading at $45.125 a share. Once Blodget arrived at Merrill (at the start of the class period), he began the process of inflating 24/7's price by issuing a report "reinstating coverage" and assigning an "Accumulate/Buy" (2-1) rating, with a "12-18 month price objective of around $75."

By August 11, 1999, 24/7's share price had declined to $26.75, a drop of 42% from the $46 secondary offering price of April 27. To halt the decline, Respondents issued a report upgrading 24/7 from "Accumulate/Buy" to "Buy/Buy." After that report was issued, 24/7 stock halted its recent slide and surged ahead by $2.25 per share, or nearly 10%, to close at $29.00 per share the next day.

On September 9, 1999, Merrill issued a report that allayed concerns over successive downward revisions of 24/7 earnings per share estimates by increasing estimates of 1999 and 2000 revenue 17% and 19%, respectively, and stating that 24/7 "remains significantly undervalued relative to

comparative stocks." This report and two other equally positive September reports boosted the price. By November 9, 1999, the stock closed at $44.625 per share.

Respondents issued yet another report on November 3, 1999, reiterating their belief that the stock was undervalued, identifying 24/7 as a potential acquisition target and, for the first time, introducing a new valuation method – valuing 24/7 on a "breakup basis" – to justify the continued "Buy" recommendation in light of poor earnings performance. The November 3, 1999 report caused 24/7 stock to jump in a single day by more that $6.50 per share, or more than 14 percent, to close at $51.1875 per share.

Barely one month later, Merrill reignited the 24/7 engine by issuing another report, emphasizing the new "breakup valuation" theory. The December 9, 1999 report caused 24/7 stock to increase by more that $9 per share over the next two trading days, or more than 17%, to close at $63.4375 per share on December 12, 1999.

On December 20, 1999, Respondents raised the price target for 24/7 stock to $85 per share. The next day, 24/7 reached its all-time high of $65.25.

On March 6, 2000, Virginia Syer, an Internet Group analyst and co-author with Blodget of the 24/7 reports, drafted an analyst report which she emailed to Blodget for his approval, commenting that she was "trying to be oblique to help stock in anticipation of downgrade on wed [nesday] [sic] - so we can say we were expecting great Q4." However, rather than a downgrade consistent with their true opinion of 24/7 and without revealing their intention to "help" the stock, they reiterated their "Buy Buy" rating. The March 7, 2000 report caused 24/7 stock to increase by $3.62 per share over the next two trading days, or more than 7 percent from its close of $51.50 per share the previous day to close at $55.125 per

share on March 8, 2000. By March 13, 24/7 again hit $60 per share.

Respondents continued to reiterate their "Buy/Buy" ratings, issuing eight additional reports between March 9 and July 5, 2000. Some of these reports also reiterated the $85 price target. Though 24/7's stock price began its dramatic decline during this period, Respondents did not lower their rating on 24/7 until August 7, 2000, when they gave 24/7 the still favorable rating of "Accumulate/Accumulate." (A-423). By that point, the stock price had dropped from the artificially inflated Class Period high of approximately $65 per share to a still inflated $11.4375 per share.

On October 10, 2000, Internet Group analyst Eve Glatt emailed Blodget a news article about problems with 24/7's key product. She commented that the article "probably confirms what you and Virg [inia Syer] ***have talked about for some time***." *Id.* (Emphasis added.) Blodget responded: "that it's a pos [piece of shit]? yes." Respondents' private, negative views regarding 24/7's critical product, were never disclosed and were utterly at odds with their positive public recommendations.

On November 9, 2000 Respondents finally succumbed to reality and downgraded 24/7 to a near-term and long-term "Neutral." As a result of the downgrade, 24/7's stock dropped from the prior day close of $4.64 per share, to close at $2.9375 per share on November 9, 2000, a loss of 36% of the stock's already greatly diminished price, which traded as high as $64.625 during the Class Period.

B. Proceedings Below

1. Coordination of the Cases

On April 8, 2002 the New York Attorney General's Office (the "AG") filed the Affidavit of Eric Dinallo in Support of Application for an Order Pursuant to [New York] General Business Law Sec. 354, and accompanying exhibits (the "Dinallo Affidavit"), disclosing that Respondents, as a matter of course, did not believe their own recommendations and operated under undisclosed conflicts of interest with respect to their Internet research coverage. The first complaint in the 24/7 action was filed on April 25, 2002. Other similar actions were filed around the same time. An MDL panel subsequently centralized all of the Merrill research report cases in the Southern District of New York. These cases were then coordinated by security, and by Order of the District Court, one plaintiff was appointed as lead plaintiff for each security. Thereafter, amended complaints were filed on March 13, 2003.

2. Motions to Dismiss

Respondents moved against these cases in stages, choosing to proceed first with actions brought by 24/7 and Interliant shareholders. With regard to loss causation, the Respondents argued that the losses were not caused by a public, corrective disclosure of the analyst fraud but by the intervening "bursting" of the Internet bubble as a result of which the prices of many Internet stocks tumbled. After oral argument, the motion to dismiss the 24/7 and Interliant Complaints was granted on June 30, 2003 on several grounds, including statute of limitations and loss causation. Pet. App. 64a – 126a. Petitioner's motions to reconsider and for leave to amend (with an amended complaint attached) were denied on August 12, 2003. Pet. App. 33a – 63a. Petitioner timely appealed.

3. The Decision on Appeal

A three-judge panel of the United States Court of Appeals for the Second Circuit reversed the decision of the District Court that the complaints were barred by the statute of limitations, but affirmed the decision that the complaints failed properly to plead "loss causation". *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005); Pet App. 1a – 32a.[2]

The Second Circuit held that a plaintiff must allege "that the misstatement or omission concealed something from the market that, ***when disclosed***, negatively affected the value of the security." *Id.* at 173; Pet. App. 22a. (emphasis added). Under this theory, a plaintiff must demonstrate that a loss was both "foreseeable" and "caused by the materialization of the concealed risk." *Id.* This theory of loss causation is premised on the assumption that artificial inflation can be reduced or eliminated from a stock price ***only*** through disclosure of the fraud, whereas, in fact, artificial inflation can be – and often is – reduced or eliminated by other means.

The Court of Appeals further found that Merrill's eventual, belated downgrades of 24/7 did not amount to a corrective disclosure causing loss, as those downgrades "did not reveal to the market the falsity of the ***prior*** recommendations." *Id.* at n.4; Pet. App. 26a n.4 (emphasis added).

Finally, the panel added a heightened – and unprecedented – pleading requirement, holding that:

> [W]here . . . substantial indicia of the risk that materialized are unambiguously apparent on the face of the disclosures alleged to conceal the very same risk, a plaintiff must allege (i) facts sufficient to support an inference that it was defendant's fraud

2. The Second Circuit declined to address the other grounds for dismissal adopted by the District Court.

> rather than other salient factors — that proximately caused plaintiff's loss; or (ii) facts sufficient to apportion the losses between the disclosed and concealed portions of the risk that ultimately destroyed an investment.

Id. at 177; Pet. App. 31a.

REASONS FOR GRANTING THE PETITION

Introduction

This case warrants consideration for two reasons. ***First***, the various judicial circuits that have considered the question have articulated different standards for pleading loss causation in cases alleging artificial inflation of the purchase price. While this Court recently held that pleading artificial inflation of the purchase price was not alone sufficient, the Court did not specify what additional allegations might be sufficient to establish the causative link between a fraud that inflates the purchase price and a subsequent decline in price that results in an economic loss. *See Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627 (2005). Moreover, the heightened loss causation pleading standard announced by the Second Circuit seems in direct conflict with *Dura*'s "fair notice" standard.

Second, *Lentell* announced a new pleading standard for loss causation, and yet Petitioner was not afforded any opportunity to amend the complaint to meet the new standard, despite having proffered one loss causation amendment which was denied by the District Court, and an expanded proposed amendment that was proffered on appeal. Indeed, the Second Circuit did not address at all Petitioner's requests for leave to amend.

I. REVIEW IS NECESSARY TO RESOLVE A SPLIT AMONG THE CIRCUITS AND CLARIFY THE LOSS CAUSATION PLEADING REQUIREMENTS

A. The Second Circuit

In recent years, the Second Circuit has wrestled with various standards for pleading and proving loss causation. *See Lentell*, 396 F.3d at 173, Pet. App at 22a; *Emergent Cap. Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003); *Suez Equity Inv, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87 (2d Cir. 2001).

1. The *Suez* Standard

In 2001 in *Suez*, the Second Circuit attempted to reconcile prior "inconsistent precedents on loss causation" and held that:

> [T]he rule derived from the holdings of *Marbury Management* [*Inc. v. Kohn*, 629 F.2d 705 (2d Cir. 1980)] and *Bennett* [*v. U.S. Trust Co.*, 770 F.2d 308 (2d Cir. 1985)], is that plaintiffs may allege transaction and loss causation by averring both that they would not have entered the transaction but for the misrepresentation and that the defendants' misrepresentations induced a disparity between the transaction price and the true "investment quality" of the securities at the time of transaction.

Suez, 250 F.3d at 97-98.

The *Suez* court held that "allegations that the misrepresentations . . . led plaintiffs to appraise the value of SAM Group securities incorrectly by assuming the competency of . . . the Group's principal" went to the "investment quality" of the securities. *Id.* at 96-98. "The

Complaint thus alleges that plaintiffs suffered a loss at the time of purchase since the value of the securities was less than that represented by defendants." *Id.* at 98.

Suez aligned the Second Circuit with other circuits which have held that "'[i]n a fraud on the market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation.'" *In re Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281, 378 n.145 (S.D.N.Y. 2003) (quoting *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996), and citing *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619-20 (8th Cir. 1991)).

Under *Suez* the loss causation allegations in the Complaint (and, additionally, in the Proposed Amended complaint) would have been sufficient.

2. The *Emergent* Standard

In 2003, in *Emergent*, the Second Circuit articulated a new loss causation standard, requiring that plaintiffs allege a "price disparity" at the time of the initial purchases, plus a "causal connection between the content of the alleged misstatements or omissions" and "the harm actually suffered." 343 F.3d at 198.

One district court in the Second Circuit recognized the inconsistency between *Suez* and *Emergent*, and the confusion created thereby: "After *Emergent Capital*, this Circuit appears to have switched camps. . . . However, because the court took pains to insist that *Suez Equity* is still good law, the sweep of *Emergent Capital* is not entirely clear." *In re Initial Public Offering Sec. Litig.*, 297 F. Supp. 2d at 672. A few things, however, were made clear by *Emergent*:

First, the requirement of loss causation ought not place unrealistic burdens on a plaintiff at the initial pleading stage.

Thus, *Emergent* held: "If the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation will not be established. ***But such is a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion***." *Emergent*, 343 F.3d at 197 (emphasis added).

Second, there was no requirement that plaintiffs allege a corrective disclosure. Indeed, the *Emergent* plaintiffs' losses were incurred long before the "pump and dump" scheme was discovered; and there was never a corrective disclosure triggering plaintiff's losses. *Emergent*, 343 F.3d at 191, 193-94, 197-98. Under *Emergent* the allegations in the Complaint, or in the Proposed Amended Complaint, would have been sufficient. The intervening decline in the market for Internet stocks, the "bursting of the Internet bubble," would not have been a barrier at the pleading stage to alleging that at least some of the losses were caused by the fraudulent analyst recommendations. Moreover, absence of a "corrective" disclosure of the analyst fraud would not necessarily negate loss causation, as a market correction could occur prior to disclosure of the fraud.

3. The *Lentell* Standard

Lentell has now articulated a third, stricter loss causation pleading standard – the loss must both be "foreseeable" ***and*** "caused by the materialization of the risk." *Lentell*, 396 F.3d at 173; Pet. App. at 22a. A plaintiff must allege "that the misstatement or omission concealed something from the market that, ***when disclosed***, negatively affected the value of the security." *Id.* (emphasis added). Moreover, the decision added a new pleading requirement, holding that loss causation must be plead with factual particularity:

> [W]here . . . substantial indicia of the risk that materialized are unambiguously apparent on the

> face of the disclosures alleged to conceal the very same risk, a plaintiff must allege (i) facts sufficient to support an inference that it was defendant's fraud — rather than other salient factors — that proximately caused plaintiff's loss; or (ii) facts sufficient to apportion the losses between the disclosed and concealed portions of the risk that ultimately destroyed an investment.

Id. at 177; Pet. App. 31a. Petitioner's Proposed Amended Complaint would have satisfied this standard.

B. The Seventh Circuit

The Seventh Circuit holds plaintiffs to an arduous loss causation standard. Plaintiffs must "allege and prove that, but for the defendant's wrongdoing, the plaintiff would not have incurred the harm of which he complains." *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir. 1990), *see also Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 648 (7th Cir. 1997) ("To plead loss causation, the plaintiff must allege that it was the very facts about which the defendant lied which caused its injuries."). The test adopted by the Seventh Circuit "constitutes a high-water mark in the area of causation pleading." *In re Rhythms Secs. Litig.*, 300 F. Supp. 2d 1081, 1092 (D. Colo. 2004).

In *Bastian* the court held that alleged misrepresentations concerning an oil and gas limited partnership were not the cause of the losses, in the face of a steady decline in oil and gas prices subsequent to the plaintiff's investment. *Bastian*, 892 F.2d at 682. Since the "oil and gas ventures failed not because of the personal shortcomings that the defendants concealed but because of industry-wide phenomena that destroyed all or most such ventures," then the "plaintiffs, given their demonstrated desire to invest in such ventures, lost nothing by reason of the defendants' fraud." *Id.* at 685.

Even this so-called "high water mark" is less strict than *Lentell* and would have permitted the 24/7 complaint to survive. One recent District Court decision in the Seventh Circuit makes this clear:

> In the typical loss causation situation, the plaintiff alleges inflation of the stock price due to defendants' painting the company in a favorable, albeit untruthful, light, disclosure of the true state of the company at some later point, and an immediate decline in the stock price as a result of market reaction to the belated disclosure. . . . Defendants try to cast plaintiffs' claims in this mold, characterizing plaintiffs' loss as a drop in USN's stock price after the disclosure in November 1998 of certain "true" facts about the dire state at USN. Defendants argue the November 1998 disclosure could not cause the loss because USN's stock prices declined steadily during the class period. . . .
>
> Defendants' argument is unpersuasive. Plaintiffs do not contend that it was disclosure of USN's true financial state in November 1998 that caused the stock price to decline and thereby cause their loss. Rather, plaintiffs allege that their losses resulted from paying an inflated price for USN stock because of the misrepresentations and omissions occurring prior to and throughout the class period. . . . ***According to plaintiffs, the market responded to and "corrected" the price of USN stock over the better part of a year as bits and pieces of negative information became available*** and it became apparent that USN was not capable of performing as originally represented. ***Plaintiffs' allegations of an inflated***

purchase price suffice to meet their burden of pleading loss causation.

Danis v. USN Communs., Inc., 73 F. Supp. 2d 923, 943 (N.D. Ill. 1999) (emphasis added).

Thus, even under the Seventh Circuit standard, the District Court in *Danis* explicitly rejected the limiting notion that artificial inflation in a stock price can be reduced or eliminated ***only*** through a corrective disclosure of the fraud.

C. The Eleventh Circuit

The Eleventh Circuit joins the Seventh in applying a stringent loss causation standard. *See Robbins v. Koger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997). *Robbins* held that establishing loss causation "explicitly require[s] proof of a causal connection between the misrepresentation and the investment's subsequent decline in value." *Id.* at 1448.[3] An allegation that a plaintiff has purchased an artificially inflated stock is insufficient to demonstrate loss causation absent some "evidence that this price inflation was removed from the market price of [a defendant's] stock, causing plaintiffs a loss." *Id.* at 1448.

Robbins conflicts with *Lentell*'s requirement of an explicit corrective disclosure of the fraud. Pet. App. 22a.

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3. The Eleventh Circuit, consistent with *Dura*, rejected the argument that price inflation at the time of purchase, without more, can satisfy the loss causation requirement, emphasizing that its decisions "explicitly require proof of a causal connection between the misrepresentation and the investment's subsequent decline in value." Because the court found no evidence that the price inflation alleged at the time of plaintiffs' purchase was ever removed from the market price of Koger's stock, or that the dividend cuts, which led to the drop in price, were related to the alleged misrepresentations, the court held that the plaintiffs failed to satisfy the loss causation requirement. *Id.* at 1146-47.

While requiring that the artificial inflation be removed from the stock price before a plaintiff can properly demonstrate loss causation, it does not suggest that the removal must occur ***exclusively*** through an explicit disclosure of the fraud.

In *Robbins*, the Eleventh Circuit also adopted what it described as an "intermediate approach" to pleading loss causation where there are intervening market forces. *Id.* at 1147. Because market responses are the result of many different and often unknowable factors, a plaintiff not need show that the defendant's misconduct was the sole and exclusive cause of the investment's decline in value, but only that it was a "substantial" factor or "significant contributing cause" of his injury. *Id.* at 1147 n.5.

Again, the 24/7 complaint or the Proposed Amended Complaint would have survived. The intervening decline in Internet stock prices would not have precluded the argument that a substantial portion of the decline in the price of 24/7 was the removal from the price of the analyst-induced inflation as a result of the operation of normal, market corrective forces, even if another portion of the decline was related to the general bursting of the Internet bubble.

D. The Third Circuit

The Third Circuit holds that a plaintiff must establish "that the alleged misrepresentations proximately caused the decline in the security's value to satisfy the element of loss causation." *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000). A plaintiff who alleges that the price of a security was artificially inflated the artificial inflation was removed by a market correction has adequately alleged loss causation. *Id.* ("In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price.").

Although the Third Circuit requires that artificial inflation be removed from the price, it has not required that the removal necessarily stem from contemporaneous disclosure of the fraud. The Third Circuit's standard in the face of intervening market forces is similar to that of the Eleventh Circuit and inconsistent with *Lentell*. Pet. App. at 1a – 32a. Noting that "[i]t is well established that not every intervening event is sufficient to break the chain of causation," the Third Circuit holds that "[s]o long as the alleged misrepresentations were a substantial cause of the inflation in the price of a security, other contributing forces will not bar recovery." *Semerenko*, 223 F.3d at 187. Thus, when there were multiple potential causes for the inflated value of a stock price – some fraudulent and some not – it could not be presumed, at least at the motion to dismiss stage, that loss causation did not exist. *Id.*

E. *Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627 (2005)

On April 19, 2005, the Court decided *Dura Pharms.*, which held that a plaintiff cannot satisfy the "loss causation" requirement merely by pleading that the "price *on the date of purchase* was inflated because of the misrepresentation." 125 S. Ct. at 1631 (emphasis in original). The Court declined to articulate what more *was* needed to satisfy the loss causation pleading requirement. *Id.* at 1633-34 ("We need not, and do not, consider other proximate cause or loss-related questions.").

Dura did not rule that allegations of a fraudulently inflated purchase can never form part of a properly pled theory of loss causation, nor did it foreclose the theory pled in 24/7 and other analyst fraud cases. Although the opinion noted that "the logical link between the inflated share purchase price and any later economic loss is not invariably strong," under some circumstances "[i]f the purchaser sells

later after the truth makes its way into the market place, an initially inflated purchase price *might* mean a later loss." *Id.* at 1632 (emphasis in original). The opinion did not state that the truth must necessarily enter the market through a corrective disclosure of the prior fraud, and did not foreclose a theory that the truth was gradually revealed to the market through the normal operation of the forces of supply and demand.

As to the pleading burden, *Dura* requires only that loss causation be pled according to the "fair notice" standard – "it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and causal connection that the plaintiff has in mind." *Dura Pharms*, 125 S. Ct. at 1634. In this respect *Lentell*'s heightened, fact intensive loss causation pleading requirement is inconsistent with *Dura*.

The 24/7 complaint meets the *Dura* standard. It does not allege purchase price inflation alone but identifies the economic loss as the subsequent decline in price of the stock up to and including the time when the analyst ratings were belatedly downgraded, and it explains the causal connection between the subsequent price decline and the initial analyst-engendered price inflation in terms of the foreseeable operation of supply and demand. Several federal district judges have found similar loss causation theories to be logical and to meet the relevant pleading requirements. *Swack*, 2004 U.S. Dist. LEXIS 22749 at *14; *Fogarazzo v. Lehman Brothers, Inc.*, 341 F. Supp. 2d 274, 292 (S.D.N.Y. 2004); *Danis*, 73 F. Supp. 2d at 943; *Retsky Family Ltd. Partnership v. Price Waterhouse LLP*, No. 97-7694, 2001 U.S. Dist. Lexis 20397 **12-14 (N.D. Ill. 1998).

The *Lentell* standard, foreclosing a showing of loss causation absent a corrective disclosure of the fraud, ignores the practical reality that market forces often correct for and

eliminate the price inflation over time, *before* the fraudulent conduct is discovered or revealed. A properly framed loss causation inquiry should be: (1) was the stock price inflated by the fraud, and (2) was the inflation reduced or eliminated from the stock price leading to a loss at the time of sale.

Such a standard reflects "the reality . . . that stock prices sometimes self-correct in advance of the final overt disclosure." *Swack*, 2004 U.S. Dist. LEXIS 22749 at *14. *See also Fogarazzo*, 341 F. Supp. 2d at 292. ("[I]nflated stock prices can lead to a loss in one of two ways... First, there can be an external correction to the market, such as a corrective disclosure. . . . Second, there can be a market correction, where ordinary market forces affect the rate of artificial inflation."). As the *Swack* court held:

> In some cases, of course, information that could only be known by the company . . . comes to light suddenly, precipitating a dramatic sell-off. In other cases-of which analysts' public ratings may be a good example-the misleading information is one factor in a soup of other publicly available data. At one point, data that seem [sic] inconsistent with the analyst's rating may be discounted by the market on the theory that the analyst-who after all studies the company as his full-time job and is supposedly part of a "credible and insightful team" that is encouraged "to interpret [industry] information in a fair and objective manner"- has good reason to believe that the company's prospects are better than the data indicate. ***As the gap between rating and reality widens, however, the analyst's ratings gradually lose credibility and the market values them less and less. By the time the analyst bows to reality and adjusts his rating (and/or discloses the conflict that led to the misleadingly bullish rating), the market may***

> ***not be paying much attention, having already recognized the truth.***

Id. (emphasis added) (citing *Danis*, 73 F. Supp. 2d at 943 and *Retsky*, 2001 U.S. Dist. Lexis 20397 at **12-14).

That is what happened here. Merrill artificially inflated the market price of 24/7 stock by inducing more purchase demand at higher prices than would have existed in a market untainted by the fraudulent research reports.[4] The scheme contained the seeds of later losses by concealing the risk that the price would eventually erode by market forces, subjecting investors to a greater risk of a larger loss than comparable investments.[5] "Thus, the publication of the intentionally false opinions that allegedly distorted the market price of [the] stock contained the seeds of loss causation." *DeMarco v. Robertson Stephens, Inc.*, No. 03 Civ. 590, 2004 U.S. Dist. LEXIS at *32 (S.D.N.Y. Jan. 9, 2004).

The Court should grant the petition to clarify both the loss causation element and the pleading standard in cases where there has been an artificial inflation of the purchase price but the economic loss (the removal of the inflated portion of the price) has already occurred by operation of market forces before the fraud is publicly revealed.

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4. The 24/7 complaint cited several examples where sharp increases in the market price of the stock followed Merrill buy recommendations. *Lentell* properly assumes the truth of the allegations that Merrill caused price inflation. *Lentell*, 396 F.3d at 165; Pet. App. at 4a.

5. *Lentell* stated: "Nor do plaintiffs allege that Merrill Lynch concealed or misstated any risks ***associated with an investment*** in 24/7 Media or Interliant, some of which presumably caused plaintiffs' loss." 396 F.3d at 175; Pet. App. at 27a (emphasis added). Petitioner submits that the real risk of market erosion of the artificial price inflation subjected buyers to a greater risk of risk of investment loss that was concealed by Merrill's fraud.

II. SUPREME COURT REVIEW IS NECESSARY TO CLARIFY THAT DUE PROCESS REQUIRES LEAVE TO AMEND WHEN THE COURT OF APPEALS ADOPTS A NEW, MORE STRINGENT PLEADING STANDARD.

This "Court traditionally has held that the Due Process Clauses protect civil litigants who seek recourse in the courts . . . as plaintiffs attempting to redress grievances." *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 429 (U.S. 1982). This protection stems from the procedural component of the Due Process Clauses of the Fifth and the Fourteenth Amendments, which bars state or federal action having the effect of depriving a person of "life, liberty, or property, without due process of law." U.S. CONST. AMEND. V, IV.

Determining if a due process violation has occurred involves a two pronged inquiry. First, a court must determine if the complaining party "was deprived of a protected interest," and, if so, the Court must determine if that party received appropriate procedural protections before that deprivation occurred. *Logan*, 455 U.S. at 428. As such, the inquiry here is, first, if Petitioner had a protected interest in his cause of action and, if so, if the Second Circuit adequately protected that interest when dismissing Petitioner's complaint under a standard Petitioner never had opportunity to meet.

Both of these prongs are met in the present case. First, it is beyond dispute that "a cause of action is a species of property protected by the . . . Due Process Clause." *Logan*, 455 U.S. at 428 (applying Fourteenth Amendment); *see also Societe Internationale Pour Participations Industrielles et Commerciales, S. A. v. Rogers*, 357 U.S. 197, 209 (1958) (noting Fifth Amendment provided "constitutional limitations upon the power of courts, even in aid of their own valid processes, to dismiss an action without affording a party the opportunity *for a hearing on* the merits of his

cause."). It is similarly beyond dispute that dismissing a complaint, with prejudice, deprives the litigant of this recognized property interest. *Societe Internationale*, 357 U.S. at 211.

The question here thus turns on whether the Second Circuit provided the requisite procedural protections before dismissing Petitioner's Complaint with prejudice; the answer, manifestly, is no.

Lentell announced a new and more stringent standard for pleading loss causation.[6] Jurists have long noted the fundamental unfairness of "granting a dismissal on the pleadings without leave to amend based on a new legal standard that the drafter of the complaint had no way of anticipating." *Sun-Land Nurseries, Inc. v. Southern California Dist. Council of Lanorers*, 793 F.2d 1110, 1121 (9th Cir. 1986) (Browning, J. dissenting); *see also Brown v. Coach Stores*, 163 F.3d 706, 714 (2d Cir. 1998) (Newman, J., dissenting); *see also* U.S. Const. Am. V ("No person shall . . . be deprived of life, liberty, or property, without due process of law.") In an analogous circumstance, courts (including this Court) have held that denying a litigant before an administrative panel the opportunity to meet a new standard of law amounts to a denial of due process. *See Hatch v. Federal Energy Regulatory Com.*, 654 F.2d 825, 835 (D.C. Cir. 1981) ("Supreme Court cases suggest that . . . notice and opportunity to meet [a] new standard is a constitutional imperative of due process. . . .") (citing *West Ohio Gas Co. v. Public Utilities Comm'n*, 294 U.S. 63, 70-71 (1935); *Morgan v. United States*, 304 U.S. 1 (1938); *Joint Anti-Fascist Refugee Committee v. McGrath*, 341 U.S. 123, 165-66 (1951) (Frankfurter, J., concurring). As this is the precise situation presented here, dismissal of Petitioner's complaint

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6. Indeed, Petitioner was faced with three separate pleading standards in the course of this litigation. *See* § I(A), *supra*.

amounts to a denial of due process and this Court should grant certiorari to make this clear.

Lentell holds that Petitioner must allege "facts sufficient to support an inference that it was defendant's fraud rather than other salient facts that proximately caused plaintiff's loss or . . . to apportion the losses between the disclosed and concealed portions of the risk that ultimately destroyed the investment." *Lentell*, 396 F.3d at 177; Pet. App. at 31a. This fact-intensive pleading standard is inconsistent with precedent and could not have been anticipated. *See Dura Pharms.*, 125 S. Ct. at 1634 ("[O]rdinary pleading rules are not meant to impose a great burden upon a plaintiff"); *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997) (the loss causation requirement "ought not place unrealistic burdens on the plaintiff at the initial pleading stage").[7]

Despite the heightened burden, Petitioner were and are prepared to meet it in an amended pleading.[8] In 24/7,

[7] No other court requires that loss causation be pled with such particularity. See *In re Electronic Data Sys. Corp. Sec. and ERISA Litig.*, 298 F. Supp. 2d 544, 560 (E.D. Tex. 2004); *Coates v. Heartland Wireless Communications, Inc.*, 26 F. Supp. 2d 910, 923 (N.D. Tex. 1998). On the contrary, such a fact intensive inquiry requires expert analysis and is more properly addressed at summary judgment or trial. *See Gebhardt v. Conagra Foods, Inc.*, 335 F.3d 824, 831-832 (8th Cir. 2003); *Tracinda Corp. v. Daimlerchrysler AG*, 197 F. Supp. 2d 42, 67-68 (D. Del. 2002); *Blatt v. Muse Tech., Inc.*, No. 01-11010, 2002 WL 31107537 (D. Mass. Aug. 27, 2002); *see also* Daniel R. Fischel, *Use of Modern Finance Theory In Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1, 17-19 (1982); Jay W. Eisenhofer, Geoffey C. Jarvis & James Banko, *Securities Fraud, Stock Price Valuation and Loss Causation: Toward A Corporate Finance-Based Theory of Loss Causation*, 59 Bus. Law. 1419, 1421, 1444-45 (2004).

[8] In light of the changing legal landscape, Petitioner requested leave to amend before the District Court and before the Second Circuit. The former denied it, while the latter ignored it.

Petitioner sought from the District Court, but was denied, leave to amend to show that the price of 24/7 stock declined substantially more than the decline in the Internet stock sector as a whole.[9] Pet. App. at 33a. The amendment compared the decline in the price of 24/7 stock from its peak price to the end of the class period (95.5%) with the decline in the Dow Jones Composite Internet Index (46.8%). 24/7 stock fell more than twice the amount that could arguably be attributable to the burst of the Internet bubble. The purpose of the amendment was to add a fact-based allegation from which it could be reasonably inferred that a substantial part of the economic loss was not caused by the intervening Internet collapse but by artificial price inflation induced by the analyst's fraud.

Petitioner proffered to the Second Circuit that he would also amend to allege that all sixteen of the individual Merrill-covered Internet stocks in this coordinated litigation declined more than the Internet sector as whole — on average they fell 93%, while the Dow Jones Internet Index fell only 61% over the comparative time periods. Petitioner submits that these facts support a reasonable and logical inference that an ascertainable portion of the losses were caused by Merrill's fraud, as opposed to other salient factors, such as the general downturn in the Internet market.[10] Petitioner also indicated that he may submit allegations based on expert opinion,

9. The 24/7 proposed amendment also included allegations negating the possibility that company-specific events caused the substantial decline in 24/7 relative to the Internet sector as a whole.

10. The general downturn in the Internet sector has enabled Merrill to cloud the issue by arguing the losses were caused by an intervening event. However, as this data shows, that downturn did not cause "comparable losses to other investors," in Internet stocks not affected by Merrill's fraud. *Lentell*, 396 F.3d at 174; Pet. App. at 25a. Investors in Merrill-covered stocks suffered much greater declines and "would have been spared . . . an ascertainable portion of that loss absent the fraud." *Lentell*, 396 F.3d at 174; Pet. App. at 26a.

which would ordinarily be reserved for summary judgment or trial, analyzing all of the factors, both market-wide and company-specific, that might have contributed to portions of the stock price declines.

Petitioner should have been granted leave to file the proffered amendments, and the District Court denied Petitioner this procedural protection. Pet. App. at 33a. The Second Circuit did not address the issue or articulate any reasons that would support the lower court's denial of leave. Pet. App. at 1a-32a.

CONCLUSION

For the foregoing reasons, Petitioner respectfully requests that the Court grant his Petition for a Writ of Certiorari.

Respectfully submitted,

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APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DECIDED JANUARY 20, 2005

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

August Term, 2003

(Argued: August 12, 2004 Decided: January 20, 2005)

Docket No. 03-7948

John Kilgour Lentell, Brett Raynes and Juliet Raynes,

Plaintiffs-Appellants,

– v. –

Merrill Lynch & Co. Inc. and Henry M. Blodget,

Defendants-Appellees,

Thomas P. Willcutts, on behalf of himself and all others similarly situated, Yolanda Rice, individually and on behalf of all others similarly situated, Neil Trama, on behalf of himself and all others similarly situated, Brent Wickam, individually and on behalf of all others similarly situated, Marie Forte, on behalf of herself and all others similarly situated, C. Anthony Martignetti Trust, and on behalf of those similarly situated, Bob Raiano, individually and on behalf of those similarly situated, Christophe De Reynal, individually and on behalf of all others similarly situated, Diane Pilgrim, individually and on behalf of all others

similarly situated, Turgut Ergun, on behalf of himself and all others similarly situated, Doug Seidenburg, individually and on behalf of all others similarly situated, Robert Rueben, on behalf of himself and all others similarly situated and Fulgham, individually and on behalf of all others similarly situated,

Consolidated-Plaintiffs,

Abraham Twersky Family Trust, on behalf of itself and all others similarly situated and John Deleo, on behalf of himself and all others similarly situated,

Plaintiffs.

DENNIS JACOBS, *Circuit Judge*:

John Kilgour Lentell and Brett and Juliet Raynes, as lead plaintiffs for purchasers of the publicly traded stock of two internet companies, appeal from the dismissal by the United States District Court for the Southern District of New York (Pollack, *J.*) of their securities-fraud actions against Merrill Lynch & Co. and its former star analyst, Henry M. Blodget (collectively, "Merrill Lynch," "Merrill," or "the Firm"). In a nutshell, plaintiffs allege that Merrill, through Blodget and other research analysts, issued false and misleading reports recommending that investors purchase shares of 24/7 Real Media, Inc. ("24/7 Media") and Interliant, Inc. ("Interliant"), even though the analysts did not then believe that those companies were a good investment. It is alleged that analysts were touted to investors as independent assessors of business prospects, but that they issued the

falsely optimistic recommendations to cultivate the Firm's investment-banking clients.

In a thorough opinion, Judge Pollack concluded: [i] that the suits were time-barred and (in any event) that they fail [ii] to plead loss causation, [iii] to plead fraud with the particularity required by Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act of 1995 ("PSLRA"), and [iv] to overcome the "bespeaks caution" doctrine. We conclude that the underlying complaints were timely filed, but we affirm the dismissal on the ground that the complaints fail to plead that the alleged misrepresentations and omissions caused the claimed losses.

BACKGROUND

These securities-fraud suits arise from an investigation by the New York Attorney General ("NYAG") into investment recommendations and research issued by prominent financial institutions, including Merrill Lynch. The NYAG sought a state court order in April 2002 compelling the production of documents, testimony, and other evidence by Merrill Lynch and several of its current and former employees. The supporting affidavit outlined a scheme by Merrill Lynch's research arm to publish bogus analysis in an effort to generate investment banking business. The NYAG's papers cited dozens of internal communications that expressed bluntly negative views on internet stocks that the Firm's analysts were then recommending to the investing public.

Within weeks, some 140 class-action complaints were filed, relying on the NYAG's application to allege securities fraud in connection with Merrill Lynch's analyses and

investment recommendations concerning 27 publicly traded internet companies—including 24/7 Media and Interliant. *See In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 273 F. Supp. 2d 351, 357-59 (S.D.N.Y. 2003). The Judicial Panel on Multi-District Litigation ("MDL") transferred these cases to Judge Pollack, *see id.*, who consolidated the cases, appointed lead plaintiffs (by issuer), and ruled that the 24/7 Media and Interliant actions would proceed first and together. *Id.* at 359 n. 14. Amended, consolidated class-action complaints were filed in February 2003; the dispositive issue on appeal is the sufficiency of those complaints.

I

Because we assume plaintiff's factual allegations to be true on review of a motion to dismiss pursuant to Rule 12(b)(6), *DeMuria v. Hawkes*, 328 F.3d 704, 706 (2d Cir. 2003), the facts of Merrill Lynch's fraud are taken from the amended complaints and any documents upon which they rely. *See Rothman v. Gregor*, 220 F.3d 81, 88-89 (2d Cir. 2000).

Merrill Lynch employs analysts to study and publish research and investment recommendations on a wide range of publicly traded companies. The Firm's Internet Group covers so-called new economy companies that emerged in the 1990s as investment was ignited by electronic commerce and other internet-based business models. Merrill Lynch is also an investment bank; among the services it provides in that capacity, Merrill assists companies seeking access to the capital markets by underwriting public offerings of securities. In theory, a "Chinese Wall" isolated Merrill's Internet Group

analysts from the investment bankers soliciting business from companies in the new economy. Plaintiffs claim that the Chinese Wall was breached.

A. The Alleged Fraud

Identical frauds are alleged as to 24/7 Media and Interliant: the publication by Merrill Lynch's Internet Group of false and misleading research and investment recommendations "aimed at fraudulently driving up the market prices of [those] companies . . . and motivated by the desire to obtain and maintain investment banking business for Merrill Lynch." "The result of the scheme was to manipulate, inflate and maintain the market prices of the securities of the Internet companies at artificially high levels . . . [and w]hen the market prices of the Internet companies fell, public investors lost hundreds of millions of dollars." The complaints challenge approximately 80 reports issued during a combined class period of May 12, 1999 through February 20, 2001. *Merrill Lynch*, 273 F. Supp. 2d at 360. Henry Blodget—then a star analyst—headed the Internet Group throughout the putative class periods, and he figures prominently in plaintiffs' allegations.

The scheme had five elements common to research published on 24/7 Media and Interliant:

> (i) "the public issuance and maintenance of knowingly or recklessly false, bullish research reports";

(ii) the publication of false "BUY or ACCUMULATE recommendations" on 24/7 Media and Interliant;

(iii) the setting of "profoundly unrealistic price targets for [those] stocks";

(iv) the existence of undisclosed agreements between Merrill Lynch and 24/7 Media and Interliant to " 'trade' favorable, bullish Analyst Reports for investment banking business directed to Merrill Lynch"; and

(v) the undisclosed "sharing of investment banking fees among Merrill Lynch and its internet analysts."

The false "buy" and "accumulate" recommendations appear in each of the challenged reports. Analyses issued on 24/7 Media and Interliant during the combined class periods were of three types: "Comments"; briefer, but largely similar "Bulletins"; and the terse "Morning Call Notes" (for 24/7 Media) and "Intra-Day Special Notes" (for Interliant). Page one of every challenged Comment and Bulletin includes a four-barreled "Investment Opinion" expressed in the form "X-a-b-c" where (according to the margin notes) "X" is an "Investment Risk Rating" that ranged from "A" to "D"; "a" is a number keyed to intermediate "Appreciation Potential Rating," *i.e.*, a prediction of the investment's growth potential over the ensuing twelve months; "b" is a number keyed to long-term "Appreciation Potential Rating," *i.e.*, a prediction of growth potential on a time-line greater than one year; and

"c" is a number keyed to "Income Rating," *i.e.*, a prediction of likely dividend payout.

Only the Appreciation Potential Ratings are alleged to have been false and misleading. Those ratings appeared in the full "Investment Opinion" offered in every challenged report, as well as in prominent, free-standing recommendations heading each Comment and Bulletin issued during the combined class period.[1] According to the reports, appreciation potential was rated on a six-point scale: 1—Buy; 2—Accumulate; 3—Neutral; 4—Reduce; 5—Sell; 6—No Rating. During the combined class period, the long-term and intermediate appreciation potentials for 24/7 Media and Interliant were never rated below "neutral," and only rarely below "buy" or "accumulate." Plaintiffs allege that this was *de facto* a 3-point ratings system, and that the ever-optimistic recommendations were bait and reward for investment-banking business.

B. The 24/7 Media and Interliant Allegations

24/7 Media "provides marketing solutions to the digital advertising industry." Merrill Lynch acted as lead underwriter for two public offerings made by 24/7 Media in August 1998

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1. For example, Merrill published a 24/7 Media "Bulletin" on September 15, 1999, offering the Investment Opinion "D-1-1-9," *i.e.*, "High" investment risk; "Buy" for medium-term appreciation potential, "Buy" for long-term appreciation potential, and "No Cash Dividend" likely. The Appreciation Potential Ratings also appear as recommendations at the top right-hand corner on the front page, *i.e.*, **BUY** and, immediately below, in smaller typeface, **Long Term BUY.**

and April 1999. Plaintiffs challenge as materially false and misleading each of the approximately 45 reports issued by Merrill's Internet Group from May 12, 1999 through November 9, 2000. The stock-appreciation potential of 24/7 Media was rated at "accumulate" or "buy" throughout that period, until it was downgraded to "neutral" on November 9, 2000. The stock price gyrated from $45.125 on May 12, 1999, to a high of $64.625, and to a low of $2.9375 at the close of the putative class period.

According to plaintiffs, the 24/7 Media research reports—"particularly [the] 'ACCUMULATE' and 'BUY' recommendations"—were false and misleading, and failed to disclose that Merrill Lynch and Blodget "had a policy and practice throughout the Class Period of never issuing . . . [a] rating or recommendation . . . other than 'BUY' or 'ACCUMULATE' " because to do so "would jeopardize Merrill Lynch's . . . ability to obtain underwriting or investment advisory engagements." It is further alleged that the reports were issued primarily as a means to artificially inflate the price of 24/7 Media stock, and that the appreciation ratings were "nothing more than undisclosed 'momentum' plays—i.e. the stock should be bought because its price will rise, even though there are no rational economic reasons why the stock should trade at its current price . . . [or] why the stock price should continue to rise."

Similar allegations are made with respect to the Internet Group's coverage of Interliant, a provider of "enhanced Internet services that enable[d its] customers to deploy and manage their Web sites and network-based applications." Merrill Lynch acted as co-lead underwriter of Interliant's

initial public offering in July 1999. Plaintiffs challenge as false and misleading each of the approximately 35 reports issued by the Internet Group between August 4, 1999 (when coverage initiated with intermediate and long-term appreciation ratings of "Accumulate" and "Buy") and February 20, 2001 (after which the stock was downgraded from "Buy/Buy" to "Accumulate/Accumulate"). Interliant was trading at $16.375 when Merrill initiated coverage, rose to a high of $55.50, and had plummeted to $4.00 as of February 21, 2001, the day after the putative class period closed. Throughout this period, Merrill's investment-banking arm assisted Interliant in its acquisition of 27 companies, and underwrote a $150 million convertible-bond offering in February 2000.

Plaintiffs challenge the veracity and completeness of the Interliant research reports in allegations virtually identical to those made regarding the 24/7 Media reports: the intermediate and long-term appreciation ratings were false and misleading; they were intended to artificially inflate Interliant's share price and to encourage Interliant and other internet-sector companies to use Merrill Lynch for investment-banking services; and the ratings had no rational economic basis.

Plaintiffs filed amended, consolidated class-action complaints in February 2003 and Merrill promptly moved to dismiss for failure to state a claim. Judge Pollack granted defendants' motion, citing numerous pleading deficiencies. This appeal followed.

Appendix A

DISCUSSION

We review *de novo* a district court's dismissal of a complaint for failure to state a claim. *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 194 (2d Cir. 2003). The district court catalogued numerous deficiencies in the consolidated complaints, *Merrill Lynch*, 273 F. Supp. 2d at 361-82; because we affirm their dismissal on the ground that plaintiffs failed to plead loss causation, we address only that issue and, antecedently, the statute of limitations.

I

"Section 10(b) of the Securities Exchange Act of 1934 provides that '[n]o action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.' " *LC Capital Partners, LP v. Frontier Ins. Group, Inc.*, 318 F.3d 148, 154 (2d Cir. 2003) (quoting 15 U.S.C. § 78i(e) (2000)). The limitations period begins to run "after the plaintiff 'obtains actual knowledge of the facts giving rise to the action or notice of the facts, which in the exercise of reasonable diligence, would have led to actual knowledge.' " *Id.* (quoting *Kahn v. Kohlberg, Kravis, Roberts & Co.*, 970 F.2d 1030, 1042 (2d Cir. 1992)) (emphasis omitted).

Inquiry notice—often called "storm warnings" in the securities context—gives rise to a duty of inquiry "when the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded."

Levitt v. Bear Stearns & Co., Inc., 340 F.3d 94, 101 (2d Cir. 2003) (quoting *Dodds v. Cigna Sec.*, 12 F.3d 346, 350 (2d Cir. 1993)); *see also Newman v. Warnaco Group, Inc.*, 335 F.3d 187, 193 (2d Cir. 2003) ("[T]he existence of fraud must be a probability, not a possibility."). In such circumstances, the imputation of knowledge will be timed in one of two ways: (i) "[i]f the investor makes no inquiry once the duty arises, knowledge will be imputed as of the date the duty arose"; and (ii) if some inquiry is made, "we will impute knowledge of what an investor in the exercise of reasonable diligence[ ] should have discovered concerning the fraud, and in such cases the limitations period begins to run from the date such inquiry should have revealed the fraud." *LC Capital,* 318 F.3d at 154 (citation and internal quotation marks omitted).

Where inquiry notice is clearly established, *see Newman*, 335 F.3d at 193, dismissal of a securities-fraud complaint as untimely may be readily affirmed; but " 'the applicable statute of limitations should not precipitate groundless or premature suits by requiring plaintiffs to file suit before they can discover with the exercise of reasonable diligence the necessary facts to support their claims,' " *Rothman*, 220 F.3d at 97 (quoting *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1202 (10th Cir. 1998)). "[W]hether a plaintiff had sufficient facts to place it on inquiry notice is 'often inappropriate for resolution on a motion to dismiss.' " *LC Capital*, 318 F.3d at 156 (quoting *Marks v. CDW Computer Ctr., Inc.*, 122 F.3d 363, 367 (7th Cir. 1997)). In contrast, where "the facts needed for determination of when a reasonable investor of ordinary intelligence would have been aware of the existence of fraud can be gleaned from the complaint and papers . . . integral to

the complaint," we can readily resolve the issue on a motion to dismiss, and have done so in " 'a vast number of cases.' " *LC Capital*, 318 F.3d at 156 (quoting *Dodds*, 12 F.3d at 352 n. 3). The district court concluded that plaintiffs were on inquiry notice of Merrill's alleged fraud "years prior to the filing of the[se] cases," *Merrill Lynch*, 273 F. Supp. 2d at 382, and dismissed the complaints as untimely filed. We disagree.

Any fraud must be pled with particularity, Fed. R. Civ. P. 9(b); but the rule is applied assiduously to securities fraud. This Circuit's strict pleading requirements in securities-fraud cases, *see Novak v. Kasaks*, 216 F.3d 300, 307-10 (2d Cir. 2000), were (essentially) codified in the Private Securities Litigation Reform Act of 1995, *id.* at 309-11. So no claim should be filed unless and until it can be supported by specific factual allegations. *See, e.g., Levitt*, 340 F.3d at 104 ("[C]omplaints in federal securities fraud cases [must] allege 'those events which they assert give rise to a strong inference that [the] defendants had knowledge of th[e] facts . . . or recklessly disregarded their existence,' including 'when the[ ] particular events occurred.' ") (quoting *Ross v. A.H. Robins Co.*, 607 F.2d 545, 558 (2d Cir. 1979)). A ripe claim will keep only for one year, but "[t]he triggering . . . data must be such that it relates *directly* to the misrepresentations and omissions the Plaintiffs allege in their action against the defendants." *Newman*, 335 F.3d at 193 (emphasis added) (citation and quotation marks omitted).

We have had frequent occasion to apply these rules. *See, e.g., Levitt v. Bear Stearns, Co.*, 340 F.3d 94 (2d Cir. 2003); *Newman v. Warnaco Group, Inc.*, 335 F.3d 187

(2d Cir. 2003); *LC Capital Partners, LP v. Frontier Ins. Group, Inc.*, 318 F.3d 148 (2d Cir. 2003). Our recent decisions reinforce the fact-specific nature of the limitations defense, particularly where the claim is foreclosed by inquiry notice. Storm warnings in the form of company-specific information probative of fraud will trigger a duty to investigate. For example, in *LC Capital* we concluded that three substantial charges taken against reserves by an issuer between 1994 and 1998 put plaintiffs on notice of probable wrongdoing more than a year before their untimely complaint was filed. *LC Capital*, 318 F.3d at 154-57. Pleading with sufficient particularity may be especially difficult with claims against a "secondary" or "tertiary" wrongdoer (as opposed to an issuer or its officers or directors). *See, e.g.*, *Levitt*, 340 F.3d at 102-04 (vacating the dismissal of a complaint against an issuer's clearing agent where the district court failed to ascertain whether plaintiffs had access to facts sufficient to make out a claim of primary liability under § 10(b)). We have been decidedly reluctant to foreclose such claims as untimely absent a manifest indication that plaintiffs "could have learned" the facts underpinning their allegations more than a year prior to filing. *See id.*

No such clear indication appears in this record. The fraud is alleged against a third party rather than against 24/7 Media or Interliant. True, the Internet Group's misleading statements and omissions were allegedly motivated by Merrill's desire to win banking business from (*inter alia*) 24/7 Media and Interliant, but plaintiffs do not challenge any specific securities offering (or other investment-banking transactions) undertaken on behalf of either company. This is not a fraud that can be apprehended "simply by examining . . . financial

statements and media coverage" of the issuers. *See Levitt*, 340 F.3d at 103-04; *cf. LC Capital*, 318 F.3d at 155 (probability of fraud could be gleaned from substantial reserves charges disclosed in issuer's financial and other public statements).

The 140 securities-fraud complaints consolidated before Judge Pollack were filed shortly after the NYAG sought to compel the production of documents and other evidence in its investigation of Merrill's research practices. That investigation was undertaken pursuant to the Martin Act, N.Y. Gen Bus. L. § 352 *et seq.*, which "proscribes a wide array of business practices in connection with the sale of securities," such as publication of fraudulent issuer-related research. The NYAG's supporting affidavit catalogued many specific examples of such research issued by Merrill Lynch, not to prove a violation of federal securities law, but simply to compel additional discovery. Thus it was arguably sufficient for the NYAG to allege specific facts concerning Merrill's coverage of one issuer to make a case for discovery pertaining to a wholly different issuer or issuers. But such pleading does not suffice to plead federal securities fraud. The district court correctly consolidated the complaints issuer-by-issuer and required plaintiffs to allege facts "*specific to the security in question*," including "who said what to whom concerning that *particular security*." *In re Merrill Lynch & Co.*, No. 02 MDL 1484, 2003 WL 253187, Case Management Order No. 3 (S.D.N.Y. Feb. 5, 2003) (emphasis added).

By the same token, however, the one-year limitation period of § 10(b) is triggered only by data that "relates *directly* to the misrepresentations and omissions" that

plaintiffs allege against Merrill Lynch. *Newman*, 335 F.3d at 193 (emphasis added) (citation and quotation marks omitted). The dispositive question is whether the data held sufficient by the district court meets this standard.

Plaintiffs filed amended, consolidated class-action complaints in February 2003, which were dismissed as untimely four months later. *Merrill Lynch*, 273 F. Supp. 2d at 382. According to the district court, a duty to investigate the conflicts of interest among Merrill's research analysts and investment bankers arose "years prior to the filing of the[se] cases" when numerous generic articles on the subject of structural conflicts appeared in the financial press. *Id.* The eleven articles cited by the court, published between May 2, 1996 and June 12, 2000, were insufficient as a matter of law to put plaintiffs on inquiry notice of the frauds alleged with respect to the Internet Group's coverage of 24/7 Media and Interliant. *See id.* at 382-89. Many of the articles cited by the district court were published before 24/7 Media or Interliant went public.[2] Pre-IPO articles could not prompt an investigation of the Internet Group's coverage of 24/7 Media and Interliant because when the pieces appeared, plaintiffs could not have been holding the securities of either company, nor could Merrill Lynch have recommended them.

The post-IPO articles are a closer question, as each describes (in a style echoed in the complaints) the conflicts of interest faced by a research analyst employed at a Wall

2. Four articles appeared before 24/7 Media went public on August 13, 1998; seven went to press before Interliant's public float on July 7, 1999.

Street investment bank. For example, in October 1998 (two months after 24/7 Media's IPO), Business Week reported that "the 'Chinese Wall' that on paper still separates a firm's analysts from its investment bankers continues to crumble as analysts are encouraged to scout deals," *Merrill Lynch*, 273 F. Supp. 2d at 385 (quoting Jeffrey M. Ladderman, *Who Can You Trust? Wall Street's Spin Game*, Bus. Week, Oct. 5, 1998, at 148); that an observed consequence of this breakdown was the virtual elimination of "sell" ratings from the Wall Street analyst's lexicon, *see id.* at 386-88; and that many banks (including Merrill) tied analysts' compensation to the firm's investment-banking income, *id.* In the district court's view, this "plethora of public information would have required even a *blind, deaf, or indifferent* investor to take notice of the purported alleged 'fraud,' " so that "[e]very investor of reasonable intelligence would have been absolutely on inquiry notice." *Id.* at 389 (emphasis in original).

Conflicts of interest present opportunities for fraud, but they do not, standing alone, evidence fraud—let alone furnish a basis sufficiently particular to support a fraud complaint. Nor does the existence of temptation trigger a duty of inquiry—at least, not by a reasonable investor. Something more than conflicted interest is required, no matter how well publicized the conflict may be. Plaintiffs do allege something more: that Merrill's analysts were actually corrupted as evidenced by investment opinions that were not just "systematically overly optimistic," *Merrill Lynch*, 273 F. Supp. 2d at 383 (quoting Steve Bailey & Steven Syre, *Taking Analysts' Tempting Forecasts with a Grain of Salt*, Boston Globe, Oct. 23, 1996, at C1), but demonstrably false. In support, plaintiffs point to emails collected during the

NYAG's 2002 Martin Act investigation; the district court, however, found sufficient evidence of corruption in the public domain well before that investigation picked up steam. The articles relied upon to support that finding fall well short of the specificity required to prompt further inquiry by a reasonable investor.

The articles cited by the district court strongly suggest grounds to believe that certain investment recommendations were less than candid. Well before the underlying complaints were filed, it was reported that "[a]nalysts routinely play up good news and sugarcoat the bad," *id.* at 385 (citation omitted); that "[t]he analyst today is an investment banker in sheep's clothing," *id.* at 386 (citation omitted); that "[i]n public, Wall Street brokers say that their research is objective," but "[p]rivately, they concede that 'sell' ratings are bad for investment-banking business," *id.* (citation omitted); and that "too many analysts [are] keen to report that 'what looks like a frog is really a prince,' " *id.* at 386-87 (citation omitted). One anecdote goes beyond innuendo and metaphor: following Blodget's decision to upgrade the investment recommendation on a particular stock, Blodget commented cheerily that " 'it's dead money for a while, but I want to differentiate it from all the pieces of [expletive] we have buys on.' " *Id.* at 388 (quoting David Streitfeld, *Analyst with a Knack for Shaking up Net Stocks; Henry Blodget is Wall Street's Link Between Online Firms, Investors*, Wash. Post, Apr. 2, 2000, at H1). However, that comment says nothing about 24/7 Media or Interliant; neither company is mentioned in *any* article relied upon by the district court.

If Blodget's lone remark is sufficient to put a reasonable investor on inquiry notice of the frauds alleged in the 24/7 Media and Interliant complaints, then plaintiffs had a viable fraud claim with respect to every issuer covered by Merrill's Internet Group no later than April 2, 2000.[3] And if the conflicts of interest catalogued by the financial press were sufficient to trigger § 10(b)'s one-year limitation period, then the publication of a single investment recommendation by an underwriting bank would sustain a claim for securities fraud. Such a result is incompatible with the congressional intent of the PSLRA "to deter strike suits wherein opportunistic private plaintiffs file securities fraud claims of dubious merit in order to exact large settlement recoveries." *Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000) (citation and quotation marks omitted). We do not mean to suggest that inquiry notice could never be established on the basis of non-specific public-pronouncements, but the level of particularity in pleading required by the PSLRA is such that inquiry notice can be established only where the triggering data "relates *directly* to the misrepresentations and omissions" alleged. *Newman*, 335 F.3d at 193 (emphasis added) (citation and quotation marks omitted); *see also La Grasta v. First Union Sec., Inc.*, 358 F.3d 840, 846 (11th Cir. 2004) (finding earliest inquiry notice of stock analyst's conflict of interest to be a published interview in which she referenced the conflict with respect to the specific security). The articles cited by the district court describe the conflicted situation of Wall Street's research analysts; but

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3. Defense counsel expressed skepticism at a similar line of argument; indeed, counsel was unwilling to concede any scenario in which complaints based on allegations of a type made by plaintiffs would be timely. We make no such categorical determination here.

evidence of the outright falsity of Merrill Lynch's investment recommendations is stray and indiscriminate at best, and is insufficient to put plaintiffs on inquiry notice of the specific frauds alleged. Furthermore, where (as here) plaintiffs' allegations rely on internal communications that (arguably) could not be discovered absent a government-initiated investigation, we will not "punish [a] pleader for waiting until the appropriate factual information [has been] gathered by dismissing the complaint as time-barred." *Levitt*, 340 F.3d at 104.

For these reasons we reverse the district court's ruling on the statute of limitations. We turn now to the sufficiency of plaintiffs' timely allegations.

II

It is alleged (i) that Merrill's analysts did not actually believe 24/7 Media or Interliant securities were a good investment when they encouraged the public to buy them; (ii) that the analysts' reports failed to disclose that the Firm's true motivation for publishing the fraudulent recommendations was to attract investment banking business; and (iii) that as a result of Merrill's misstatements and omissions, plaintiffs bought the stocks and, when their value plummeted, lost millions of dollars.

To state a claim for relief under § 10(b) and Rule 10b-5, plaintiffs must allege that Merrill Lynch "(1) made misstatements or omissions of material fact; (2) with scienter; (3) in connection with the purchase or sale of securities; (4) upon which plaintiffs relied; and (5) that plaintiffs'

reliance was the proximate cause of their injury." *In re IBM Securities Litigation*, 163 F.3d 102, 106 (2d Cir. 1998). The district court found the complaints deficient in numerous respects, including that plaintiffs failed to satisfy the particularity requirements of Rule 9(b) and the PSLRA, or to overcome the "bespeaks caution" doctrine. *Merrill Lynch*, 273 F. Supp. 2d at 368-78. We do not address these alternative bases for dismissal because, assuming away any other pleading defects, the district court correctly found that plaintiffs failed to plead that Merrill Lynch's misstatements and omissions caused their investment losses. *Id.* at 362-68.

It is long settled that a securities-fraud plaintiff "must prove both transaction and loss causation." *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994) (citing *Citibank N.A. v. K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992)); *see also Mfrs. Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13, 20-21 (2d Cir. 1986); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974).

Transaction causation is akin to reliance, and requires only an allegation that "but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction." *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003). Plaintiffs do not claim to have read Merrill's reports, or to have bought 24/7 Media or Interliant securities through the Firm; instead, they rely on the fraud-on-the-market presumption blessed in *Basic v. Levinson*, 485 U.S. 224, 247 (1988). We assume for present purposes that the allegations could amount to a fraud on the market. Moreover, Merrill Lynch does not contest transaction

causation at this stage, so the appellate issue is whether the complaints adequately plead loss causation.

Loss causation "is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." *Emergent Capital*, 343 F.3d at 197. The PSLRA codified this judge-made requirement: "In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). We have described loss causation in terms of the tort-law concept of proximate cause, *i.e.*, "that the damages suffered by plaintiff must be a foreseeable consequence of any misrepresentation or material omission," *id.* (quoting *Castellano v. Young & Rubicam*, 257 F.3d 171, 186 (2d Cir. 2001)); but the tort analogy is imperfect. A foreseeable injury at common law is one proximately caused by the defendant's fault, but it cannot ordinarily be said that a drop in the value of a security is "caused" by the misstatements or omissions made about it, as opposed to the underlying circumstance that is concealed or misstated. Put another way, a misstatement or omission is the "proximate cause" of an investment loss if the risk that caused the loss was within the zone of risk *concealed* by the misrepresentations and omissions alleged by a disappointed investor. *See AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 238 (2d Cir. 2000) (Winter, *J.*, dissenting).

Thus to establish loss causation, "a plaintiff must allege . . . that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered," *Suez Equity*

Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 95 (2d Cir. 2001) (emphasis added), *i.e.*, that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security. Otherwise, the loss in question was not foreseeable.

We acknowledge that the pleading principles set out in the foregoing passage require both that the loss be foreseeable *and* that the loss be caused by the materialization of the concealed risk; and we further acknowledge that our opinion in *Suez Equity* can be (mis-)read to say that this Circuit has rejected the "materialization of risk" approach. *Suez Equity* does not purport to express this Circuit's authoritative position, because that wording: (i) is *dicta* consigned to a footnote; (ii) is framed in terms that are tentative and speculative, *see id.* at 98 n. 1 ("The standard that we have employed in this opinion *attempts* to reconcile *what we view* as our *somewhat* inconsistent precedents on loss causation.") (emphasis added); and (iii) is expressly limited to what was (in 2001) "our precedents *to date*," *id.* (emphasis added). This Court's cases—post-*Suez* and pre-*Suez*—require both that the loss be foreseeable *and* that the loss be caused by the materialization of the concealed risk. *See Emergent Capital*, 343 F.3d at 197 ("Similar to loss causation, the proximate cause element of common law fraud requires that plaintiff adequately allege a causal connection between defendants' non-disclosures and the subsequent decline in . . . value. . . ."); *id.* at 198 (loss causation satisfied where the plaintiffs "specifically asserted a causal connection between the concealed information . . . and the ultimate failure of the venture"); *Castellano*, 257 F.3d at 190 ("[a] jury could find that by failing to disclose material information

. . . [defendant] disguised the very risk to which [plaintiff] fell victim"); *id.* at 188 ("a jury could find that foreseeability links the omitted information and the ultimate injury in this case"); *First Nationwide Bank*, 27 F.3d at 769 (loss causation requires a showing "that the misstatements were the reason the transaction turned out to be a losing one"); *Citibank*, 968 F.2d at 1495 ("To establish loss causation a plaintiff must show, that the economic harm that it suffered *occurred as a result of* the alleged misrepresentations.") (emphasis in original).

As this Court stated in *Castellano*:

> If the significance of the truth is such as to cause a reasonable investor to consider seriously a zone of risk that would be perceived as remote or highly unlikely by one believing the fraud, and the loss ultimately suffered is within that zone, then a misrepresentation or omission as to that information may be deemed a foreseeable or proximate cause of the loss.

257 F.3d at 188 (quoting *AUSA Life Ins.*, 206 F.3d at 235 (Winter, *J.*, dissenting)); *see also Suez Equity*, 250 F.3d at 97 ("it would have been foreseeable to defendants that facts concealed . . . would have indicated [the executive's] inability to run the Group, and would have forecast its (eventually fatal) liquidity problems"); *id.* at 98 ("Since defendants reasonably could have foreseen that [the executive's] concealed lack of skill would cause the company's eventual liquidity problems, defendants' misrepresentations may be the causal precursor to the Group's final failure."). *But see*,

e.g., *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 708-10 (2d Cir. 1980) (allegation that fraud induced investor to make an investment and to persevere with that investment sufficient to establish loss causation). We follow the holdings of *Emergent Capital*, *Castellano*, and *Suez Equity*.

Members of this Court have disagreed as to whether certain losses were attributable to a concealed risk, *see AUSA Life Ins.*, 206 F.3d at 224-28 (Jacobs, *J.*, concurring in the mandate); but our precedents make clear that loss causation has to do with the relationship between the plaintiff's investment loss and the information misstated or concealed by the defendant. *See Emergent Capital*, 343 F.3d at 198-99; *Castellano*, 257 F.3d at 186- 90; *Suez Equity*, 250 F.3d at 96-98. If that relationship is sufficiently direct, loss causation is established, *see, e.g.*, *Suez Equity*, 250 F.3d at 98 (finding that a CEO's "concealed lack of managerial ability" induced the company's failure); but if the connection is attenuated, or if the plaintiff fails to "demonstrate a causal connection between the content of the alleged misstatements or omissions and 'the harm actually suffered,' " *Emergent Capital*, 343 F.3d at 199 (quoting *Suez Equity*, 250 F.3d at 95), a fraud claim will not lie. *See, e.g.*, *Citibank*, 968 F.2d at 1494-96 (finding defendant's nondisclosure of a seven-week bridge loan insufficiently connected to plaintiff's loss to establish causation). That is because the loss-causation requirement—as with the foreseeability limitation in tort—"is intended 'to fix a legal limit on a person's responsibility, even for wrongful acts.' " *Castellano*, 257 F.3d at 186 (quoting *First Nationwide Bank*, 27 F.3d at 769-70).

Appendix A

Loss causation is a fact-based inquiry and the degree of difficulty in pleading will be affected by circumstances, but our precedents establish certain parameters. It is not enough to allege that a defendant's misrepresentations and omissions induced a "purchase-time value disparity" between the price paid for a security and its "true 'investment quality.' " *Emergent Capital*, 343 F.3d at 198 (clarifying *Suez Equity*, 250 F.3d at 97-99). Such an allegation—which is "nothing more than a paraphrased allegation of transaction causation"—explains why a particular investment was made, but does not speak to the relationship between the fraud and the loss of the investment. *Emergent Capital*, 343 F.3d at 198; *see also Robbins v. Koger Props. Inc.*, 116 F.3d 1441 (11th Cir. 1997). "[I]f the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation . . . is a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss." *Emergent Capital*, 343 F.3d at 197. However, "when the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases," and a plaintiff's claim fails when "it has not adequately ple[ ]d facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events." *First Nationwide Bank*, 27 F.3d at 772. Though all reasonable inferences are drawn in the plaintiff's favor on a motion to dismiss on the pleadings, "conclusions of law or unwarranted deductions of fact are not admitted." *Id.* at 771 (citation omitted).

Plaintiffs allege that when they invested, they were relying on the integrity of the market (including the fraudulent recommendations and omissions made by Merrill Lynch

during the putative class periods), that the shares plummeted, and that their investments became virtually worthless. To plead loss causation, the complaints must allege facts that support an inference that Merrill's misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud. As the district court found, no such allegations are made. *Merrill Lynch*, 273 F. Supp. 2d at 367-68. There is no allegation that the market reacted negatively to a corrective disclosure regarding the falsity of Merrill's "buy" and "accumulate" recommendations[4] and no allegation that Merrill misstated or omitted risks that did lead to the loss. This is fatal under Second Circuit precedent.

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4. Plaintiffs contend that they *have* alleged a corrective disclosure to the market, in alleging that Merrill's eventual downgrades of 24/7 Media and Interliant stock (from "accumulate" to "neutral" and from "buy" to "accumulate," respectively) negatively impacted the price of those securities. These allegations do not amount to a corrective disclosure, however, because they do not reveal to the market the falsity of the prior recommendations. To the contrary, plaintiffs have argued (affirmatively) on this appeal that the falsity of Merrill's recommendations was made public no earlier than April 2002, when the NYAG's affidavit "describ[ed] the inner workings of Merrill's Internet Group," and that until then plaintiffs (and presumably the market at large) therefore lacked knowledge of the fraud. The complaints withstand the statute of limitations on the strength of that argument. By the same token, however, Merrill's concealed opinions regarding 24/7 Media and Interliant stock could not have caused a decrease in the value of those companies before the concealment was made public.

Appendix A

As noted, to establish loss causation, "a plaintiff must allege . . . that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered." *Suez Equity*, 250 F.3d at 95 (emphasis added). It is alleged that Merrill's "buy" and "accumulate" recommendations were false and misleading with respect to 24/7 Media and Interliant, and that those recommendations artificially inflated the value of 24/7 Media and Interliant stock. However, plaintiffs do not allege that the subject of those false recommendations (that investors should buy or accumulate 24/7 Media and Interliant stock), or any corrective disclosure regarding the falsity of those recommendations, is the cause of the *decline* in stock value that plaintiffs claim as their loss. Nor do plaintiffs allege that Merrill Lynch concealed or misstated any risks associated with an investment in 24/7 Media or Interliant, some of which presumably caused plaintiffs' loss. Plaintiffs therefore failed to allege loss causation, as that requirement is set out in *Emergent Capital*, *Castellano*, and *Suez Equity*.

Plaintiffs do allege that Merrill's "material misrepresentations and omissions induced a disparity between the transaction price and the true 'investment quality' " of 24/7 Media and Interliant securities; "that the market price of [the] securities was artificially inflated"; and that the securities were acquired "at artificially inflated prices and [the plaintiffs] were damaged thereby." Assuming (as we must) the truth of these allegations, they may establish transaction causation; but they do not provide the necessary causal link between Merrill's fraud and plaintiffs' losses. *Emergent Capital*, 343 F.3d at 198.

It is further alleged that plaintiffs were injured "because the risks that materialized were risks of which they were unaware as a result of Defendants' scheme to defraud," and that they would not have been injured absent the scheme. But that is a legal conclusion; missing are the necessary allegations of fact to support the conclusion. The only misrepresentation that can inhere to the "buy" and "accumulate" recommendations is that they were not Merrill's true and sincere opinion. Yet plaintiffs allege no loss resulting from the market's realization that the opinions were false, or that Merrill concealed any risk that could plausibly (let alone foreseeably) have caused plaintiffs' loss. In fact, as the district court recognized, plaintiffs fail to grapple in any meaningful way with the complexity of the reports that form the basis of their claims or, for that matter, to account for the price-volatility risk inherent in the stocks they chose to buy. *See, e.g., Merrill Lynch*, 273 F. Supp. 2d at 367-68.

The essence of plaintiffs' claim is that the Internet Group's ratings for medium— and long-term Appreciation Potential (*i.e.*, the "buy" and "accumulate" recommendations) issued during the putative class periods were false and misleading. Issue is taken with certain other aspects of the reports,[5] but plaintiffs do not challenge the detailed financial information and investment analysis published alongside Merrill's fraudulent recommendations. It is thus incontestible

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5. Plaintiffs challenge the reports' "bullish" price targets and the "Reason for Report" indicated on each, but do not challenge the substantive analysis offered with respect to 24/7 Media and Interliant.

that the risk of price volatility—and hence, the risk of implosion—is apparent on the face of every report challenged in the underlying complaints. Merrill's fraudulent "buy" and "accumulate" ratings appear as part of an "Investment Opinion" that includes an "Investment Risk Rating." As described earlier, Merrill rates investment risk on a four-point scale, from "A" ("Low"), to "D"[6] ("High"). 24/7 Media and Interliant were rated as D-grade investments throughout the putative class periods. *Merrill Lynch*, 273 F. Supp. 2d at 361. Since the Investment Opinions are decoded in the margin of every "Bulletin" and "Comment" cited in the underlying complaints, the high-risk nature of the investment in 24/7 Media and Interliant was available to the marketplace just as readily as Merrill's Appreciation Potential Ratings, along with all the other information contained in the challenged reports. *See Basic*, 485 U.S. at 247 (noting that "most publicly available information is reflected in market price").

In addition to this systematic and consistent risk indicator, the research reports are full of (unchallenged) analysis, *see Merrill Lynch*, 273 F. Supp. 2d at 367-68, suggesting that 24/7 Media and Interliant were volatile investments, and therefore subject to sudden and substantial

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6. According to the Policy and Procedures Manual of Merrill Lynch's Global Securities Research and Economics Group, a "D" Risk Rating indicates that a stock has "high potential for price volatility," and that the issuer "may be unseasoned, [that it may] have a small [public] float, [that] management may be untested, [that] the industry may be new, [that] the company may depend heavily on one product or service, and/or [that the company] may not have a proven track record of earnings."

devaluation risk.[7] To plead successfully that Merrill's fraud caused their losses, plaintiffs were required to allege facts to establish that the Firm's misstatements and omissions concealed the price-volatility risk (or some other risk) that materialized and played some part in diminishing the market value of 24/7 Media and Interliant.

We are told that Merrill's "buy" and "accumulate" recommendations were false and misleading, and that the Firm failed to disclose conflicts of interest, salary arrangements, and collusive agreements among analysts, bankers, and 24/7 Media and Interliant. But plaintiffs nowhere explain how or to what extent those misrepresentations and omissions *concealed* the risk of a significant devaluation of 24/7 Media and Interliant securities. The reports indicate that 24/7 Media and Interliant were high-risk investments, a designation that specifies, *inter alia*, a "high potential for price volatility," and "no proven track record of earnings." And the unchallenged financial analyses presented (*e.g.*, negative EPS ratios and consistent quarterly losses) certainly indicate weakness.

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7. Report-specific indications of devaluation risk are abundant; for example, in the 24/7 Media "Comment" and "Bulletin" issued August 12, 1999 (when the Intermediate Appreciation Potential Rating was raised from "Accumulate" to "Buy"), the final "Investment Highlight[ ]" featured on the opening page states "As always with this sector, the stock is likely to be extremely volatile." The 24/7 Media reports consistently couch share-price targets in terms of the stock's valuation relative to competitors (a method plaintiffs do not challenge); and anticipated weaknesses (through, *e.g.*, acquisitions) are reported throughout the putative class period. The Interliant reports are peppered with similar analysis. Plaintiffs do not challenge or attempt to explain how this (and much additional) information bears upon their alleged losses.

Appendix A

Plaintiffs do not allege that Merrill "doctored" or hid, or omitted this information, all of which suggests that 24/7 Media and Interliant were volatile, devaluation-prone investments and that Merrill revealed as much in its reports. This case is therefore sharply distinguishable from cases in which some or all of the risk that materialized was clearly concealed by a defendant's misstatements or omissions. *See, e.g., Suez Equity*, 250 F.3d at 97-98; *Emergent Capital*, 343 F.3d at 196-98.

We do not suggest that plaintiffs were required to allege the precise loss attributable to Merrill's fraud, or that "systematically overly optimistic" ratings of the type published by the Internet Group are categorically beyond the reach of the securities laws. But where (as here) substantial indicia of the risk that materialized are unambiguously apparent on the face of the disclosures alleged to conceal the very same risk, a plaintiff must allege (i) facts sufficient to support an inference that it was defendant's fraud—rather than other salient factors—that proximately caused plaintiff's loss; or (ii) facts sufficient to apportion the losses between the disclosed and concealed portions of the risk that ultimately destroyed an investment. Plaintiffs have done neither, and thus offer no factual basis to support the allegation that Merrill's misrepresentations and omissions caused the losses flowing from the well-disclosed volatility of securities issued by 24/7 Media and Interliant.

Finally, plaintiffs cast their claims in terms of market manipulation, pursuant to Rule 10b-5(a) and (c). We hold that where the sole basis for such claims is alleged misrepresentations or omissions, plaintiffs have not made

out a market manipulation claim under Rule 10b-5(a) and (c), and remain subject to the heightened pleading requirements of the PSLRA. *See Schnell v. Conseco, Inc.*, 43 F. Supp. 2d 438, 447-48 (S.D.N.Y. 1999) (B.D. Parker, *J.*) (refusing to characterize allegations as market manipulation claims where alleged "schemes to defraud" consisted largely of an aggregation of material misrepresentations to inflate stock, such as research reports containing misrepresentations of the underlying facts and use of false names to solicit investors).

CONCLUSION

For the foregoing reasons, the judgment is affirmed.

APPENDIX B — ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

02 MDL 1484 (MP)
IN RE MERRILL LYNCH & CO., INC.
RESEARCH REPORTS SECURITIES LITIGATION

02 CV 3210 (MP)
IN RE MERRILL LYNCH & CO., INC.
24/7 REAL MEDIA, INC.
RESEARCH REPORTS SECURITIES LITIGATION

02 CV 3321 (MP)
IN RE MERRILL LYNCH & CO., INC.
INTERLIANT, INC.
RESEARCH REPORTS SECURITIES LITIGATION

ORDER

POLLACK, Senior District Judge.

Plaintiffs move for reconsideration of this Court's June 30, 2003 Decision and Order dismissing with prejudice the amended complaints in the 24/7 Real Media, Inc. (24/7) and Interliant, Inc. (Interliant) consolidated actions. In addition, the 24/7 plaintiffs move for amendment of the judgment and for leave to amend their consolidated amended complaint. For the reasons set forth below, the motions are denied.

Appendix B

STATUTE OF LIMITATIONS AND RULE 59(e)

Plaintiffs find fault with the Court's determination, in *Part III* of the June 30 Decision and Order, that their claims are time-barred by the statute of limitations.[1] They assert that, the Court's findings notwithstanding, they were not on inquiry notice of the alleged fraud more than one year prior to the filing of their original complaints. In support of the motion for partial reconsideration, plaintiffs rely exclusively on the Second Circuit's recent decision in *Newman v. Warnaco Group, Inc.*,[2] claiming it should alter this Court's statute of limitations analysis.

The *Warnaco* decision does not change the analysis set forth in the June 30 Decision and Order. *Warnaco* relates to a corporate change in accounting practices, an entirely different set of facts. In the cases at bar, by contrast, there are no such comparable allegations. In their motion papers, plaintiffs have done nothing to change the unalterable, judicially-noticeable facts relating to the widespread public dissemination, years prior to the filing of the cases at bar, of information regarding research analyst conflicts of interest and the service of investment banking business.

The Court's June 30 Decision and Order noted that plaintiffs' current suits, and the New York Attorney General's report which precipitated them, simply

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1. *See Decision and Order, In re Merrill Lynch & Co., Inc. Research Reports Secs. Litig.*, 02 MDL 1484, 2003 WL 21500293 (S.D.N.Y. June 30, 2003), at *19-*22.

2. 2003 WL 21518460 (2d Cir. July 7, 2003).

> brought to specific public attention certain aspects of the internal operations in securities firms that had notoriously and long existed and had been variously publicized but not focused on as undesirable conflicts that should be ameliorated, modified, conceivably controlled or eliminated.

Every complaint in this series of litigations claims it was inspired by the Dinallo Report. But, nothing in that Report acknowledges, indeed it strangely omits, any reference to the overwhelming notoriety expressed before and during the bubble, of the balancing facts of business life in the investment community (not inconsistent with ordinary understanding and experience). Some of the widely broadcast explanations that the business was not a public utility, in terms which could not have been misunderstood even by unsophisticated litigants in these suits, facts of ordinary comprehension, that were omitted in such a Report to the public, may be recalled from the following examples.[3]

(1) **May 2, 1996**, *Wall Street Journal*, "Today's Analyst Often Wears Two Hats" (Roger Lowenstein, at p. C1).

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3. "[O]n a motion to dismiss, a court may consider . . . 'matters as to which judicial notice may be taken. . . .' " *Chambers v. Time Warner, Inc.*, 282 F.3d 147, 153 (2d Cir.2002) (quoting *Brass v. American Film Technologies, Inc.*, 987 F.2d 142, 150 (2d Cir.1993)). The Court may take judicial notice of newspaper articles for the fact of their publication without transforming the motion into one for summary judgment. *See In re Sterling Foster & Co., Inc. Secs. Litig.*, 222 F.Supp.2d 312, 321 (E.D.N.Y.2002); *Schwenk v. Kavanaugh*, 4 F.Supp.2d 116, 118 (N.D.N.Y.1998).

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> Two scholars . . . looked at every IPO (save for the tiniest) in 1990 and 1991, focusing on which were recommended and by whom. Their intent was to test the objectivity of underwriters. . . .
>
> Messrs. Michaely and Womack differ from most financial scholars in that they write in English. Thus, we may quote their conclusion plainly: "The recommendations by underwriter analysts show significant evidence of bias and possible conflict of interest."
>
> Nor do the writers stint from identifying the source of conflict: Analysts get paid, in part, according to their contribution to corporate finance. To bring a company public, a firm needs its analyst on board. It is the analyst that explains-and implicitly, trumpets-the investment merits of the offering.

(2) **October 23, 1996**, *Boston Globe*, "Taking Analysts' Tempting Forecasts with Grain of Salt" (Steve Bailey & Steven Syre, at p. C1).

> [T]he bottom-line question, an important one for investors, is this: Can you trust what the analysts tell you?
>
> The mounting evidence: You trust them at your peril.

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A new study out of the Wharton School at the University of Pennsylvania and the Harvard Business School makes the case, saying analysts are systematically overly optimistic about long-term earnings forecasts for equity offerings. The researchers say the cause is the relationship between the analysts and the investment banking business that pays their bills . . .

Patricia M. Dechow and Richard G. Sloan of Wharton and Amy P. Sweeney of the Harvard Business School studied 1,179 stock offerings from 1981 to 1990. Like others before them, they found that new stock offerings underperformed the market overall; they put that underperformance at 12.7 percent over five years. . . .

The integrity of the process was always supposed to be protected by the "Chinese wall" that separated the analysts and the investment banking business. But as commissions from trading have fallen on an increasingly competitive Wall Street, investment research hasn't been able to pay its own way.

Instead, analysts have become an important sales tool for the investment bankers to land their super-profitable deals. A top analyst and the credibility he or she brings can be the difference between landing a deal or not—and the pay for the most sought-after analysts can top $5 million a year.

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Can that analyst then turn around and "dis" the firm's full-freight client? Amy Sweeney of the Harvard Business School thinks not. "It is just a huge conflict of interest for the analysts," she says.

Adams Harkness' Frankel doesn't disagree: "That pressure is clear in the industry."

(3) **June 19, 1997**, *Wall Street Journal*, "All-Star Analysts 1997 Survey" (John R. Dorfman, at p. R1).

. . . At big firms, compensation of $300,000 to $600,000 for top analysts is common, and $1 million is possible.

Analysts earn that pay in lots of ways, some of which have little or nothing to do with picking stocks or accurately estimating corporate earnings. For example, at many firms, analysts are expected to bring in investment-banking deals—the job of handling the issuance of stock or bonds for companies, or of advising companies on mergers or acquisitions.

By the unwritten laws of Wall Street, brokerage houses don't handle a stock offering unless they expect to tout its stock for a while after the offering. In Wall Street parlance, a post-offering recommendation is commonly called a "booster shot."

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Another important job of the analyst, at most firms, is to generate trading volume by getting clients excited about the recommended stocks. Even if they make superb recommendations, it's not enough for analysts to sit in a quiet room, listening to Bach and watching a computer screen. They have to work the phones, meet the clients, "pound the table" for the stocks they believe in. A great recommendation that nobody buys doesn't help the clients and doesn't make the brokerage firm any money.

(4) **April 8, 1998**, *Wall Street Journal,* "Heard in New England: Analysts May Hate to Say 'Sell,' But a Few Companies Do Hear It" (John Hechinger, at p. NE2).

Rough-and-tumble Wall Street isn't known for politeness. But many securities analysts seem to live by one childhood lesson: If you can't say something nice about a stock, don't say anything at all.

. . .

Last week, *The Wall Street Journal* asked First Call, the Boston firm that tracks investment research, to pore over analyst opinions of the 743 stocks of companies based in New England. Amazingly, only 13 companies received even one "sell" rating. . . .

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Consider the extent of this speak-no-evil policy. Out of 2,066 ratings, 68% were "buys" or "strong buys," 31% were "holds" and less than 1% were "weak sells" or "strong sells."

Critics complain that these skewed results show dangerous flaws in Wall Street's stock picking. Chuck Hill, First Call's director of research, says analysts often won't issue a "sell" because they don't like to anger companies that could be their firm's investment-banking clients.

"The pressure on analysts is growing," says Mr. Hill, a former Wall Street analyst. "The Chinese wall that existed at most brokerage houses between analysts and investment bankers has broken down."

. . .

John Adams, chairman and chief executive of Adams, Harkness & Hill, the Boston brokerage firm, says he's careful to root out positive bias in his firm's research. He claims that "sells" are scarce for a simple reason: They nearly always bear negative consequences for the analyst. Clients who hold the stock become livid, and the company's management can retaliate by keeping analysts out of the information loop. So, Mr. Adams says most analysts put out a "hold" rating, knowing that most investors consider it a "sell."

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(5) **October 5, 1998**, *Business Week*, Cover Story, "Who Can You Trust? Wall Street's Spin Game — *Stock analysts often have a hidden agenda*" (Jeffrey M. Laderman, at p. 148).

> . . . [A]nalysts who try to provide an honest and unconflicted opinion are becoming scarcer and scarcer on Wall Street. If there ever was a time when investors could use straight talk, it's now. . . .
>
> The question for investors is: "Can you trust your analyst?" Unfortunately, the answer is not very much. At the major Wall Street houses, which thrive on investment banking, every analyst has a potential conflict of interest. The "Chinese Wall" that on paper still separates a firm's analysts from its investment bankers continues to crumble as analysts are encouraged to scout deals. The analyst's firm is either the investment banker for a company he or she is covering—or it's wooing the company for a piece of that juicy revenue stream.
>
> A study co-authored by Georgia State University assistant professor Siva Nathan looked at reports on 250 companies by analysts whose firms had investment-banking ties with those companies and an equal number from analysts with no ties. The investment bankers' analysts had 6% higher earnings forecasts and nearly 25% more "buy" recommendations.

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. . .

Analysts routinely play up good news and sugarcoat the bad. Positive corporate news—an unexpectedly strong earnings report or successful product launch-may get a recommendation of "strong buy." Bad news gets a "hold" or "neutral"-often a euphemism for "sell," which has all but vanished from the analysts' vocabulary. . . .

Investors are bombarded with bullish sound bites and "strong buy" and "outperform" tips in print and on the air. . . . Investors picking up such tips need to be wary about motives. Official research reports must disclose if the firm is or has been involved in an investment-banking relationship with the company. But news reports of recommendations may not carry such disclaimers. The war between investment research and investment banking began in the 1980s, but it has heated up in the deal-crazed '90s. The reason is simple: money. Most Wall Street research is pitched to institutional investors who pay the firm about a nickel a share in commissions. But if an analyst spends his time trying to land an initial public offering, the firm can earn 15 to 30 times that amount per share. Merger advisory fees can be sweet as well. And directly or indirectly, some investment-banking fees will find their way back to the analyst's pocket. . . .

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> [W]hat happens when there's a conflict between objective analyses and the demands of investment bankers? "Conflict?" asks Brown, the former DLJ analyst. "There's no conflict. That's been settled. The investment bankers won." It's not far from the truth. "Of all the jobs on Wall Street, the company analyst's role has changed the most in the last five years," says Alan Johnson of Johnson Associates, a Wall Street compensation consultant. "The analyst today is an investment banker in sheep's clothing."

(6) **March 22, 1999**, *Crain's New York Business,* "New Executive Henry Blodget; Merrill Lynch's Top Pick: Internet Analyst Lured from CIBC; On-Target Research Should Attract IPOs" (Jon Birger, at p. 11). Plaintiffs selectively quoted from this article in their complaints (24/7 Amended Compl. ¶ 30; Interliant Amended Compl. ¶ 32).

> Mr. Blodget's value to Merrill Lynch is unmistakable. Initial public offerings have become huge moneymakers for investment banks, and firms frequently select their underwriters based upon the reputation of the analyst who covers their industry.
>
> . . .
>
> Mr. Blodget is not as unabashedly bullish as some might think. True, he is a big believer in the Internet's business potential, and at CIBC maintained "buy" ratings on most of the firms he

followed. However, his observations on the rise in Internet stocks are peppered with descriptives such as "bubble," "euphoria" and "tulip bulbs"—language usually associated with Internet skeptics.

"All stocks do not grow to the sky," says Mr. Blodget.

(7) **April 17, 1999**, *The Economist*, "Frog Spawn."

"Sell" is a four-letter word—but it is probably not out of a sense of decorum that Wall Street's financial analysts use it so rarely. Currently, "sells" account for a mere 1% of analysts' share recommendations, compared with "buys" at 68%. In the early 1980s, the ratio of buys to sells was roughly one to one. *The Economist*, along with some other market-watchers, has long suspected that the reason analysts have stopped uttering the S-word is that it no longer pays them to do so, even when they should; indeed it might get them fired.

Wall Street's top regulator, **Arthur Levitt**, chairman of the Securities and Exchange Commission, is now on the case. In a speech on April 13th he pointed out that most analysts work for firms that do business with the companies they pronounce upon. He fretted that they are under "unspoken pressures" to bring in and retain business for their firms—an analyst's compensation is often based in part on the profits

made by his bank's trading desk and its investment-banking division. And that relies on a good client relationship. "Companies quite naturally look more favorably on bankers whose analysts profess a full appreciation of their virtues." Indeed.

In public, Wall Street brokers say that their research is objective, and its extreme bullishness has been more than justified in recent years. Privately, they concede that "sell" recommendations are bad for investment-banking business—but that investors know this, and correctly read between the lines when an analyst lowers his recommendation from "strong buy" to "buy," or from that to "hold" or "neutral." Mr. Levitt is not convinced. He said he was worried that investors heard from too many analysts keen to report that "what looks like a frog is really a prince." Sadly, of course, "sometimes a frog is just a frog." Unfortunately, Wall Street financial analysis is itself a pretty ugly frog. And it is not at all clear, beyond speaking out about it, that Mr. Levitt has any way to turn it into a prince. Perhaps a kiss?

(8) **November 20, 1999**, Investors' Town Meeting, Albuquerque, New Mexico, "Remarks by SEC Chairman Arthur Levitt." (Similar remarks were given in another speech entitled "Investing with Your Eyes Open" by then-Chairman Levitt on February 12, 2000 before the *Los Angeles Times*'s 4th Annual Investment Strategies Conference in Los Angeles.)

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Now, how many of you have seen analysts from Wall Street firms on television talking about one company or another? I'm willing to bet that not many of you have thought twice about that person's recommendation to buy or sell a particular stock. But, you should.

Most analysts work for firms that have business relationships with the same companies these analysts cover. And analysts' paychecks are typically tied to the performance of their employers. You can imagine how unpopular an analyst would be who downgrades his firm's best client. Is it any wonder that today, a "sell" recommendation from an analyst is as common as a Barbara Streisand concert?

As investors, you are confronted with a dizzying number of choices and opportunities. And those options can easily overwhelm and intimidate the most financially savvy person. In this day and age, there simply is no substitute for a person's awareness and wariness.

Don't fall for the illusion of easy money. And don't be pressured by an aggressive salesman or enticed by a fancy web site promising that you'll make a fortune with one quick gamble.

(9) **March 20, 2000**, *Fortune*, Cover Story, "The High Price of Research. *Caveat Investor: Stock and research analysts covering dot-coms aren't as independent as you think*" (Erick Schonfeld, at p. 116).

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Objectivity should be the analyst's stock in trade. In the best of all worlds, analysts on Wall Street and at tech-industry research firms would spend their time giving unbiased, educated opinions about companies, markets, and trends. But in this world, filled as it is with dot-com money blowing every which way, objectivity seems a luxury few can afford. Analysts of all stripes—from Morgan Stanley's Mary Meeker on down to lowly researchers at the likes of the Aberdeen Group—increasingly derive a portion of their compensation, directly or indirectly, from the companies they cover. That helps put pressure on the quality of their work and encourages them to become more like cheerleaders than independent observers.

Let's be honest. It has always been hard to know how objective analysts really are. Consider who butters their bread. Wall Street investment banks compete to provide corporate finance services to many of the companies their analysts report on; firms such as Meta Group and Jupiter Communications sell consulting services and research to many of the companies that their analysts cover. Such basic conflicts have existed for years.

Internet mania exacerbates the problem. . . .

. . . Bill Burnham, an ex-Internet analyst at Credit Suisse First Boston and now a venture

capitalist at Softbank, puts it bluntly: "In the technology world, there is no banking relationship without the analyst." The analyst is judge, jury, and executioner when it comes to deciding whether to pursue a company as a banking client, and it is the analyst who has the closest relationship with the company after the deal is done.

"This can collapse into a situation where the analyst becomes a spokes-person for the firm he is analysing," warns Mathew Hayward, a professor at the London Business School. His research shows that companies get higher ratings from analysts they bank with than from analysts they don't. One example: Soon after Bank of America Securities underwrote a follow-on offering for theglobe.com, its analyst at the time, Alan Braverman, initiated coverage of the stock with a buy rating. The stock now trades below its initial offering price.

(10) **April 2, 2000**, *The Washington Post*, "Analyst with a Knack for Shaking up Net Stocks; Henry Blodget Is Wall Street's Link Between Online Firms, Investors" (David Streitfeld, at p. H1):

Blodget sees Amazon as a $100 stock in 12 to 18 months, which would only bring it back [down] to where it was two months ago.

And that's for a company he likes. Many of the weaker companies, he predicts, won't be around in five years. . . .

. . .

Going to upgrade, he tells an assistant as he walks out the door at 8:20 p.m. Not that he expects Amazon to go up that much. "I think it's dead money for a while, but I want to differentiate it from all the pieces of [expletive] we have buys on," he says cheerfully.

. . .

Merrill is in the running to do the underwriting for the site's [*"PlanetOut's"*] initial public offering, which makes this another conflict. If Merrill gets the job, Blodget will later be issuing reports on PlanetOut, and when was the last time an analyst was less than upbeat about a company his firm just underwrote?

"It's never happened," says author Hooke. "Any analyst whose firm does major investment banking work—and nearly all of them do—is suspect. I don't know why the SEC doesn't ask these firms to spin off their research operations."

Blodget admits that, for many analysts, "There's certainly a tendency to give the company a benefit of the doubt." But he argues that "the

> best analysts find a way of balancing the needs and wants of their constituencies."

(11) **June 12, 2000**, The Industry Standard, "Holding Analysts Accountable" (Eileen Buckley).

> It's one of Wall Street's best-known secrets, and a dirty one. Research analysts writing recommendations of closely watched Internet stocks routinely face conflicts of interest.
>
> Securities firms stand to rake in huge fees from underwriting the stock offerings of Internet companies, often the same companies that the firms' analysts recommend.

Thus, well before the internet bubble burst in March and April 2000, abundant material was in the public domain regarding the existence of widespread investment banking conflicts of interest and allegedly inflated buy ratings in Wall Street stock research, especially research related to new IPOs and technology companies. Plaintiffs make no allegation in their complaints that they read or relied upon the research reports that they allege misled them in the cases at bar. If they had read the reports, however, they would have noticed a company-specific disclosure statement, contained on each and every one of the forty-four 24/7 Real Media reports and on each of the thirty-four Interliant reports at issue, plainly admitting that defendant "was a manager of the most recent public offering of securities of this company within the last three years." All of the seventy-eight reports also contained a statement that defendant "or its affiliates may from time to

time perform investment banking or other services for, or solicit investment banking or other business from, any entity mentioned in this report."

Plaintiffs make the astounding assertion in a reply brief that the overwhelming collection of notices from the press and top securities regulatory officials "would not have allowed an investor of reasonable intelligence to piece together" the purported alleged "fraud." The plethora of public information would have required even a *blind, deaf, or indifferent* investor to take notice of the purported alleged "fraud." Every investor of reasonable intelligence would have been absolutely on inquiry notice. Plaintiffs overlook the "uncontroverted evidence [that] irrefutably demonstrates" the inquiry notice.

Having access to all of the information contained in the public domain regarding the abundantly publicized conceivable conflicts of interest, plaintiffs, after the bubble burst in March and April 2000, took no action against defendants throughout all of 2000 and 2001, even as publicity surrounding the conflicts of interest continued. In fact, plaintiffs took no action until the weeks immediately following publication of the Dinallo affidavit on April 8, 2002—almost two years after the bubble had burst. The first complaints in 24/7 and Interliant were filed on April 25 and May 1, 2002, respectively, and relied almost exclusively on the *ex parte* regulatory inquiry under New York's Martin Act.

Palpably, plaintiffs, and indeed the whole investment community, were on inquiry notice of the asserted "fraud" well more than one year prior to the filing of the complaints

herein, which invoked the one-year statute of limitations terminating these suits.[4] As indicated in *Warnaco,* the very decision upon which plaintiffs attempt to rely, "The issue that the Court must consider is not whether Plaintiffs in this case were given inadequate information about the alleged inventory fraud but whether Plaintiffs 'had constructive notice of facts sufficient to create a duty to inquire further into that matter. An investor does not have to have notice of the entire fraud being perpetrated to be on inquiry notice.' " *Newman v. Warnaco Group, Inc.,* 2003 WL 21518460, at *5 (2d Cir. July 7, 2003) (quoting *Dodds v. Cigna Sec., Inc.,* 12 F.3d 346, 350 (2d Cir.1993)). The *Warnaco* Court further made clear that "[a] plaintiff in a federal securities case will be deemed to have discovered fraud for purposes of triggering the statute of limitations when a reasonable investor of ordinary intelligence would have discovered the existence of the fraud." *Id.* (quoting *Dodds,* 12 F.3d at 350); *see also In re Merrill Lynch Ltd. Partnerships Litig.,* 154 F.3d 56, 60 (2d Cir.1998) (noting that "the question of inquiry notice need not be left to a finder of fact").

As a final note, the dramatic decline in the price of Plaintiffs' shares in early 2000 also served to put them on notice of the alleged fraud. *See Benfield v. Mocatta Metals Corp.,* 26 F.3d 19, 23 (2d Cir.1994) (loss of value of highly recommended investment in a matter of months imposed a duty of inquiry); *see also Lenz v. Associated Inns and*

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4. Maybe there is substance to the observation that may have influenced the regulators that, "Wall Street conflicts of interest are inevitable—they cannot be eradicated; they can only be policed." John C. Coffee, Jr., "Wall Street's Conflicts Cannot Be Settled," *Financial Times,* April 29, 2003.

Restaurants Co., 833 F.Supp. 362, 375 (S.D.N.Y.1993) ("This court, and others both within and without the Second Circuit, have held that clear evidence that an investment asset has declined in value or has been subject to an artificially inflated estimate of its value, in direct contradiction of representation made to the plaintiff at the time of sale, constitutes inquiry notice as to the probability of fraud."); *Hupp v. Gray*, 500 F.2d 993, 997 (7th Cir.1974) (noting that "the fact which would have put a reasonable person on notice of the possibility of fraud, namely, the drastic fall in market price, was not concealed").

PLAINTIFFS WILL NOT BE PERMITTED TO FURTHER AMEND

In addition to plaintiffs' failure to articulate a proper basis for reconsideration or for amending the judgment of dismissal to be without prejudice where only one of four grounds for dismissal is challenged in the reconsideration motion (as discussed above), plaintiffs' requests for leave to amend must be denied for at least three additional reasons: (1) plaintiffs have already amended their complaints once—with guidance from the Court—and have failed to state a claim; (2) plaintiffs' requests are untimely and procedurally improper; and (3) the proposed amendments would be futile.

a. Plaintiffs Have Already Had Ample Opportunity to Attempt to Plead Legally Sufficient Claims and Have Previously Amended Their Complaints

The 24/7 and Interliant plaintiffs have no right to a second amendment—a third bite at the apple—particularly

where, as here, they had ample opportunity to craft their complaints and were advised by the Court, prior to amending their complaints, of certain pleading deficiencies and what the Court would require. As Judge Sweet held, quoting Judge Friendly, "where a district court judge puts plaintiff's counsel 'on the plainest notice of what was required,' justice does not require the court to 'engage in still a third go-around.'" *Moran v. Kidder Peabody & Co.*, 617 F.Supp. 1065, 1068 (S.D.N.Y.1985) (quoting *Denny v. Barber*, 576 F.2d 465, 471 (2d Cir.1978) (Friendly, J.)), *aff'd mem.*, 788 F.2d 3 (2d Cir.1986); *see also Blanchard v. Katz*, 705 F.Supp. 1011, 1013-14 (S.D.N.Y.1989) (Lasker, J.) (complaint dismissed with prejudice where plaintiffs "already had an opportunity to amend the complaint with notice of its deficiencies").

This Court was explicit in its instructions to plaintiffs concerning the pleading of loss causation and pleading with the particularity required by Fed.R.Civ.P. 9(b) and Section 21D(b)(1) & (2) of the PSLRA, and plaintiffs "failed to heed" these instructions.[5] *See* 2003 WL 21500293, at * 15. For this reason alone, further amendment will not be permitted. *See*

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5. Prior to the first amendment of these complaints, this Court specifically admonished plaintiffs in Case Management Order No. 3 that "[c]onsolidated amended complaints should also be carefully framed in order that they may fully comply with all applicable law regarding the pleading of loss causation." 2003 WL 21500293, at *7. The Court also reminded plaintiffs in the same Order "that they should take special care to comply with the particularized pleading requirements."

> Each counsel who has been appointed Lead Counsel in a particular consolidated action is responsible for obtaining the necessary information such that the

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Denny, 576 F.2d at 471; *see also In re Cybershop.com Sec. Litig.*, 189 F.Supp.2d 214, 236-37 (D.N.J.2002) (Pisano, J.) (denying leave to amend, noting that "[p]laintiff ha[d] already had its proverbial 'second bite at the apple'" when, following a case management conference in which the court had given plaintiff instructions concerning its pleadings, plaintiff served its first consolidated amended complaint).

b. Plaintiffs' Request to Amend Must Be Denied As Procedurally Improper

Where, as here, plaintiffs have waited until dismissal of their claims before requesting leave to amend, leave to amend is properly denied. In *Vine v. Beneficial Fin. Co.*, the Second Circuit found that it was "certainly within the district court's discretion" to deny plaintiff leave to file a second amended complaint, where "one basis for denial of leave to amend was the bad faith of appellant in waiting to see how he would fare on the prior motion to dismiss." 374 F.2d 627, 636-37 (2d Cir.1967) (district court denied leave to amend on ground that "[t]he new information alleged in the [proposed second amended] complaint was within plaintiff's knowledge before argument of the motion to dismiss the first amended

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> consolidated amended complaint for that case will comply with the pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure and the PSLRA, in particular 15 U.S.C. § 78u-4(b)(1) & (2). The factual allegations must be specific to the security in question and should clearly allege who said what to whom concerning that security.

2003 WL 21500293, at *15.

complaint"). *Vine* is thus squarely on point here, where the purportedly "new" information was within plaintiffs' knowledge before argument on the motion to dismiss. In the June 30 Decision and Order, this Court expressly noted plaintiffs' allusion to "other 'evidence'" and that plaintiffs were aware of the appropriate procedure to amend their complaints. Accordingly, this Court correctly concluded that "[t]hey cannot hold such 'evidence' back in hopes of having yet a third bite of the proverbial apple." *Merrill Lynch*, 2003 WL 21500293, at *17 n. 52.

Plaintiffs' contention that their complaints "should not have been dismissed with prejudice" because they have "indicated an ability to amend the complaint" should be rejected not only for the reasons stated in *Vine*, 374 F.2d at 636-37, but also because the cases plaintiffs rely upon do not support their position here. (*See* 24/7 Mot. for Lv. to Amend at 4; Interliant Mot. and Mem. for Partial Recons. at 3 (citing *Gurary v. Winehouse*, 235 F.3d 792, 801 (2d Cir.2000)) (citing *Oliver Schs., Inc. v. Foley*, 930 F.2d 248, 252-53 (2d Cir.1991) (noting that leave to amend should be granted even without an explicit motion where the adverse party had knowledge of desire to amend), *cert. denied*, 534 U.S. 826 (2001))).

Plaintiffs' "indicated ability" and "desire" to amend the complaint prior to dismissal of these actions consisted of a footnote in their opposition brief explaining that although they had received "an initial production" of documents from the Attorney General's investigation, "they have not had any opportunity to conduct their own discovery," and believe that

additional documents from the Attorney General will enable them to amend.[6]

Gurary v. Winehouse, relied on by plaintiffs, actually *supports* denial of plaintiffs' request for leave to amend, where, as here, plaintiffs merely indicated in their opposition brief that they could amend their complaints. *See* 235 F.3d at 801. *Gurary* held that the court did not abuse its discretion by denying leave to amend following plaintiff's first dismissal where plaintiff's request came in an affidavit opposing defendants' motion to dismiss. *See id.* at 796, 801 (citing

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6. The Interliant plaintiffs also alluded to unspecified "additional information" that they could provide in an amended complaint if the First Amended Complaint were dismissed. Plaintiffs' opposition brief otherwise includes no request for leave to amend their complaints and plaintiffs made no request to further amend their complaints prior to the briefing on these cases, which began on April 30, 2003. Plaintiffs were also given three extensions for the purpose of filing their consolidated amended complaints.

More fundamentally, plaintiffs' suggestion that they must be afforded the opportunity to review additional documents from the New York Attorney General in hopes of finding additional documents that could be used to amend their complaints flies in the face of the objective of the PSLRA's *stay* of discovery, namely, that plaintiffs be able to plead legally sufficient claims *prior* to *any* discovery. *See* 15 U.S.C. § 78u-4(b)(3)(B). "This stay provision gives effect to Congress' intent that 'discovery should be permitted in securities class actions only after the court has sustained the legal sufficiency of the complaint.'" *Novak v. Kasaks,* No. 96 Civ. 3073, 1996 WL 467534, at *1 (S.D.N.Y. Aug. 16, 1996) (Schwartz, J.) (quoting Senate Comm. on Banking, Housing, and Urban Affairs, Private Securities Litigation Reform Act of 1995, S.Rep. No. 98, 104th Cong., 1st Sess. 14 (1995)).

Confederate Mem'l Ass'n. v. Hines, 995 F.2d 295, 299 (D.C.Cir.1993) ("[T]he district court did not abuse its discretion by denying leave to amend where plaintiffs made only a 'bare request.'")). *Oliver Schs. v. Foley*, 930 F.2d 248, 253 (2d Cir.1991), also does not support plaintiffs here because there, unlike here, the plaintiff had not previously amended its complaint. The same is true of the *Pangburn* and *Ricciuti* cases cited by the 24[7] plaintiffs in their separate motion "For Leave to Amend and to Amend the Judgment" (at 2-3). *See Pangburn v. Culbertson*, 200 F.3d 65, 68-71 (2d Cir.1999) (noting that a *pro se* litigant should have been given at least *one* opportunity to amend); *Ricciuti v. N.Y.C. Transit Auth.*, 941 F.2d 119, 123 (2d Cir.1991) (no prior amendment).

c. Amendment Would Be Futile and Is Properly Denied Here

Plaintiffs' requests for leave to amend must be denied because they have given the Court no indication that they can amend their complaints to plead legally sufficient claims. "One good reason to deny leave to amend is when such leave would be futile." *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 55 (2d Cir.1995) (noting that district court examined proposed amended pleading and determined that additional allegations of fact "did not cure the complaint"); *Chill v.*

[7] The 24 plaintiffs' assertion that they are seeking "for the first time—to cure what appears to be a primary deficiency identified by the Court's Order of June 30, 2003" is incorrect. This is not their first amendment and as noted above, the Court had specifically admonished plaintiffs about the need to adequately plead loss causation and had given plaintiffs specific guidance on pleading with specificity prior to amendment.

General Elec. Co., 101 F.3d 263, 271-72 (2d Cir.1996) (affirming dismissal without leave to replead where district court concluded "that there is no indication that plaintiffs could replead the complaint so as to establish GE's scienter"); *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 815 (2d Cir.1996) (affirming dismissal with prejudice of plaintiffs' first consolidated amended complaint because district found plaintiffs' proffers concerning additional information they could provide would not have cured pleading defects); *In re American Exp. Co. Shareholder Litig.*, 39 F.3d 395, 402 (2d Cir.1994) (stating that "leave to amend may be denied if the amendment would be futile"); *see also Cybershop.com*, 189 F.Supp.2d at 236-37 (rejecting plaintiffs' request in opposition brief to be given leave to amend if complaint dismissed where plaintiff had not demonstrated that amendment would not be futile); *Emergent Capital Inv. Management, LLC v. Stonepath Group,Inc.*, 195 F.Supp.2d 551, 563 n. 4 (S.D.N.Y.2002) (same).

In *Cybershop.com*, the Court noted potential defects in plaintiffs' pleadings prior to their filing of a consolidated amended complaint. *See* 189 F.Supp.2d at 236. Noting that plaintiff had already had one opportunity to amend when it filed the consolidated amended complaint, the Court rejected its attempt to amend again because it had already had its "proverbial 'second bite at the apple.'" *Id.*

> Plaintiff has failed to proffer any proposed, substantive amendment that would satisfy applicable pleading requirements; indeed, it does not suggest any amendment at all. Plaintiff had

> ample opportunity to craft a sufficiently pled complaint when the Court directed it to review the annual report, consolidated the thirteen pending cases in to this single class action, and ordered the lead Plaintiff to file an amended class action complaint.

Id. ("Ever mindful that leave to amend is ordinarily granted, *see* Fed.R.Civ.P. 15(a), the Court finds that any likely amendment will not cure the deficiencies plaguing the amended complaint."). The *Cybershop.com* Court further held that liberally allowing amendment is inconsistent with the PSLRA's heightened pleading standard and that courts are not required to repeatedly advise plaintiffs on how to improve their complaints. *See* 189 F.Supp.2d at 237; *see also In re NAHC, Inc. Sec. Litig.*, 306 F.3d 1314, 1332-33 (3d Cir.2002).

Here, the 24/7 and Interliant plaintiffs' proffers are insufficient to show that amendment would not be futile. The 24/7 and Interliant plaintiffs' claims were dismissed on several grounds: (i) the complaints failed adequately to allege loss causation; (ii) the complaints failed to plead fraud with particularity, including failure to plead that the statements of opinion were false; (iii) the research analysts' opinions were inactionable because they adequately bespoke caution; and (iv) plaintiffs' claims were barred by the statute of limitations.[8] Any attempt to amend claims barred by the

8. The Court also found that the complaints were objectionable because they violated Rule 8(a)(2) & (e)(2) and recognized that defendants had reasonably requested that scores of paragraphs be

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statute of limitations is futile. *See, e.g., de la Fuente v. DCI Telecomms., Inc.*, 206 F.R.D. 369, 387 (S.D.N.Y.2002) (McMahon, J.). But even were the Court to accept plaintiffs' argument that their claims are not barred by the statute of limitations—which, as discussed above, the Court will not do—the plaintiffs' motion for leave to replead does not address the three other independent grounds for dismissal and attempts only to address loss causation. Because none of the proposed amendments address all of the grounds for dismissal set forth in the Decision, the proposed amendments would necessarily be futile.

In the continually shifting sands of plaintiffs' loss causation arguments, the 24/7 plaintiffs seek to amend their Consolidated Amended Complaint yet again to add allegations that the price of 24/7 decreased more than certain internet stock indexes. Not only was this data available to plaintiffs years ago, but it utterly fails to address plaintiffs' deficiencies in pleading loss causation. The proposed allegations simply do not link any of the research reports to the decline in the price of 24/7. The price of 24/7 fell as a result of the bursting of the bubble—even if at a faster pace than the average—and the proposed allegations do not provide any facts from which it can be inferred that the 24/7 research reports were the cause of the decline. Indeed, plaintiffs allege quite the opposite (i.e., that the reports were

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stricken as immaterial under Rule 12(f) and considered dismissing them with leave to replead, but opted to work through the complaints in an attempt "to keep delays, costs and attorneys' fees at reasonable levels, and mindful of its obligation to construe pleadings so as to do substantial justice." 2003 WL 21500293, at *12-*13.

overly optimistic). Nor do the allegations provide any support for plaintiffs' theory in their opposition brief that the 24/7 research reports artificially inflated the price of 24/7 stock. In fact, the proposed allegations are inconsistent with any theory of loss causation in that they allege that the price of 24/7 underperformed against the index while Merrill Lynch issued "favorable" ratings.

Plaintiffs, in a reply memorandum, have also resorted to a hitherto undisclosed and unargued claim that in a further amended pleading they would allege that, in addition to inflating the market price of the stock by unspecified false reporting, defendants manipulated the market in the securities of 24/7 by price leadership and dominion and control of the market for the security, and attempting to reduce the floating supply of the security. Plaintiffs' proposed amendment does nothing to put forth a cognizable basis for this claim. The only attempted proof submitted is attached to the reply brief—a previously unreleased private client investor list, which allegedly purports to show that Merrill Lynch clients had the largest holdings in 24/7 as of March 1, 2000 which suffered a huge decline at that time.

Plaintiffs state that they can show thereby a "collapse of the market for the security after the manipulator's activities cease" and cite this Court's opinion in *S.E.C. v. Martino*, 255 F.Supp.2d 268, 287 (S.D.N.Y.2003) in support, as if that is meaningful.

Plaintiffs conveniently forget that the collapse of the Bubble and the market price occurred in March 2000. The drop that plaintiffs point to and would rely on eight months

later from $4.64 to $2.94 on November 9, 2000 reached there as a result of an extremely long decline occasioned months before and the November drop is not the situation considered in *Martino* in respect of the stock there involved. Plaintiffs' proposed amendment is a meaningless distraction proffered by plaintiffs and does not support or make out any semblance of a cause of action whatever.

Any flaws charged following long after an intervening market collapse do not deprive the defendants of the doctrine of loss causation, which operated herein in March 2000. By force of statute and as interpreted by the Court of Appeals in *Castellano v. Young & Rubicam:* [9]

The loss causation requirement is intended to "fix a legal limit on a person's responsibility, even for wrongful acts."

CONCLUSION

Plaintiffs' motions are denied in their entirety for the previous reasons and this supplement thereto.

So ordered.
Dated: August 12, 2003

MILTON POLLACK
SENIOR UNITED STATES DISTRICT JUDGE

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9. 257 F.3d 171, 186 (2d Cir.2001) (quoting *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir.1994)).

APPENDIX C — DECISION AND ORDER OF THE UNITED STATES DISTRICT COURT, SOUTHERN DISTRICT OF NEW YORK DATED JUNE 30, 2003

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

02 MDL 1484 (MP)

IN RE MERRILL LYNCH & CO., INC.
RESEARCH REPORTS SECURITIES LITIGATION

02 CV 3210 (MP)

IN RE MERRILL LYNCH & CO., INC.
24/7 REAL MEDIA, INC.
RESEARCH REPORTS SECURITIES LITIGATION

02 CV 3321 (MP)

IN RE MERRILL LYNCH & CO., INC.
INTERLIANT, INC.
RESEARCH REPORTS SECURITIES LITIGATION

DECISION AND ORDER

POLLACK, Senior District Judge.

Defendants *Merrill Lynch & Co., Inc.* (ML & Co.) and its wholly-owned subsidiary *Merrill Lynch, Pierce, Fenner & Smith Inc.* (MLPF & S) move to dismiss the amended class action complaints in the 24/7 Real Media, Inc. (24/7) and Interliant, Inc. (Interliant) consolidated actions for, *inter alia*, (1) failure to state a claim upon which relief can be granted,

pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, and (2) failure to plead fraud with particularity, as required by the Private Securities Litigation Reform Act of 1995 (Reform Act) (*see* 15 U.S.C. § 78u-4(b)) and Rule 9(b) of the Federal Rules of Civil Procedure. Individual defendant Henry Blodget (Blodget) joins the motion.[1] For the reasons set forth below, the motion is granted.

LEGAL STANDARDS - RULE 12(b)(6) AND FRAUD ALLEGATIONS

In deciding a motion to dismiss under Rule 12(b)(6), this Court, "accepting all factual allegations in the complaint as true and drawing all reasonable inferences in the plaintiffs' favor,"[2] must dismiss the action if "it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations."[3] The Court's role is "to assess the legal feasibility of the complaint, not to assay the weight

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1. "Defendants" is used collectively to refer to the corporate and individual defendants together throughout this opinion.

2. *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 161 (2d Cir. 2000); *see Friedl v. City of New York*, 210 F.3d 79, 83 (2d Cir. 2000); *Koppel v. 4987 Corp.*, 167 F.3d 125, 130 (2d Cir. 1999). Only "well-pleaded" allegations are accepted as true, *see Albright v. Oliver*, 510 U.S. 266, 268 (1994).

3. *In re Scholastic Corp. Secs. Litig.*, 252 F.3d 63, 69 (2d Cir. 2001) (*quoting Hishon v. King & Spalding*, 467 U.S. 69, 73 (1984)); *I. Meyer Pincus & Assoc., P.C. v. Oppenheimer & Co., Inc.*, 936 F.2d 759, 762 (2d Cir. 1991) (same).

of the evidence which might be offered in support thereof."[4] "General, conclusory allegations need not be credited, however, when they are belied by more specific allegations of the complaint."[5]

In the fraud context, plaintiffs do not enjoy a "license to base claims . . . on speculation and conclusory allegations."[6] Federal Rule of Civil Procedure 9(b) requires that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." The Second Circuit has held that, at a minimum, the complaint must identify the statements plaintiff asserts were fraudulent and why, in plaintiff's view, they were fraudulent-specifying

4. *Geisler v. Petrocelli*, 616 F.2d 636, 639 (2d Cir. 1980); *see Ricciuti v. New York City Transit Auth.*, 941 F.2d 119, 124 (2d Cir. 1991).

5. *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1092 (2d Cir. 1995) (*citing Jenkins v. S & A Chaissan & Sons, Inc.*, 449 F. Supp. 216, 227 (S.D.N.Y. 1978)); *see* 5A Charles A. Wright & Arthur R. Miller, *Federal Practice & Procedure* § 1363, at 464-65 (2d ed.1990); *see also In re American Express Co. Shareholder Litig.*, 39 F.3d 395, 400-401 & n. 3 (2d Cir. 1994) ("[C]onclusory allegations of the legal status of the defendants' acts need not be accepted as true for the purposes of ruling on a motion to dismiss.") (collecting cases).

6. *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos., Inc.*, 75 F.3d 801, 813 (2d Cir. 1996) (*quoting Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990)); *see also Segal v. Gordon*, 467 F.2d 602, 607 (2d Cir. 1972) ("Mere conclusory allegations to the effect that defendant's conduct was fraudulent or in violation of Rule 10b-5 are insufficient.") (*quoting Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 444 (2d Cir. 1971)).

who made them and where and when they were made.[7] This particularity requirement is reinforced by the Reform Act, in which Congress required that all private securities class action complaints alleging material misrepresentations or omissions "shall specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading."[8]

In deciding a Rule 12(b)(6) motion, the Court may consider the following materials: (1) facts alleged in the complaint and documents attached to it or incorporated in it by reference,[9] (2) documents "integral" to the complaint and

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7. *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993).

8. 15 U.S.C. § 78u-4(b)(1).

9. *Rothman v. Gregor*, 220 F.3d 81, 88 (2d Cir. 2000) ("For purposes of a motion to dismiss, we have deemed a complaint to include any written instrument attached to it as an exhibit or any statements or documents incorporated in it by reference. . . .") (*citing Cosmas v. Hassett*, 886 F.2d 8, 13 (2d Cir. 1989)); *Stuto v. Fleishman*, 164 F.3d 820, 826 n. 1 (2d Cir. 1999) (*citing Newman & Schwartz v. Asplundh Tree Expert Co.*, 102 F.3d 660, 662 (2d Cir. 1996)) (same).

While the Second Circuit has stated that "limited quotation does not constitute incorporation by reference," *Cosmas v. Hassett*, 886 F.2d 8, 13 (2d Cir. 1989) (*quoting Goldman v. Belden*, 754 F.2d 1059, 1066 (2d Cir. 1985)), the "line between incorporating by reference and not doing so . . . is fine," *Key v. Chase Manhattan Bank, N.A.*, 1990 WL 113185, at * 4 (S.D.N.Y. July 30, 1990) (*citing Ruff v. Genesis Holding Corp.*, 728 F. Supp. 225, 227 n. 2 (S.D.N.Y. 1990)

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relied upon in it, even if not attached or incorporated by reference,[10] (3) documents or information contained in defendant's motion papers if plaintiff has knowledge or possession of the material and relied on it in framing the complaint,[11] (4) public disclosure documents required by law

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("Because the PPM was referred to extensively throughout the Complaint, rather than merely quoted from sporadically, we regard it as having been incorporated by reference into the Complaint.") (distinguishing *Cosmas*)). *See also Oppenheimer*, 936 F.2d at 762 ("[W]e examine the prospectus together with the allegations contained on the face of the complaint. We do so . . . despite the fact that the complaint contains only 'limited quotation' from that document.").

10. *See International Audiotext Network, Inc. v. American Tel. and Tel. Co.*, 62 F.3d 69, 72 (2d Cir. 1995) ("Although the amended complaint in this case does not incorporate the Agreement, it relies heavily upon its terms and effect; therefore, the Agreement is 'integral' to the complaint, and we consider its terms in deciding whether [plaintiff] can prove any set of facts that would entitle it to relief."); *Cortec Indus., Inc. v. Sum Holding L.P.*, 949 F.2d 42, 48 (2d Cir. 1991) ("[T]he district court . . . could have viewed [the documents] on the motion to dismiss because there was undisputed notice to plaintiffs of their contents and they were integral to plaintiffs' claim"); *Oppenheimer*, 936 F.2d at 762 ("The prospectus is integral to the complaint. . . . We therefore decline to close our eyes to the contents of the prospectus and to create a rule permitting a plaintiff to evade a properly argued motion to dismiss simply because plaintiff has chosen not to attach the prospectus to the complaint or to incorporate it by reference.").

11. *Chambers v. Time Warner, Inc.*, 282 F.3d 147, 153 (2d Cir. 2002) ("[O]n a motion to dismiss, a court may consider 'documents

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to be, and that have been, filed with the Securities and Exchange Commission,[12] and (5) facts of which judicial notice may properly be taken under Rule 201 of the Federal Rules of Evidence.[13]

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attached to the complaint as an exhibit or incorporated in it by reference . . . matters of which judicial notice may be taken, or . . . documents either in plaintiffs' possession or of which plaintiffs had knowledge and relied on in bringing suit.' ") *(quoting Brass v. American Film Technologies, Inc.*, 987 F.2d 142, 150 (2d Cir. 1993)); *Rothman*, 220 F.3d at 88-89; *Cortec*, 949 F.2d at 47 ("Where plaintiff has actual notice of all the information in the movant's papers and has relied upon these documents in framing the complaint the necessity of translating a Rule 12(b)(6) motion into one under Rule 56 is largely dissipated.").

12. *Rothman*, 220 F.3d at 88; *Cortec*, 949 F.2d at 47 ("[W]hen a district court decides a motion to dismiss a complaint alleging securities fraud, it may review and consider public disclosure documents required by law to be and which actually have been filed with the SEC. . . ."); *Kramer v. Time Warner, Inc.*, 937 F.2d 767, 774 (2d Cir. 1991) (giving rationale for allowing district courts to consider this information on Rule 12(b)(6) motion).

13. *Chambers*, 282 F.3d at 153 ("[O]n a motion to dismiss, a court may consider . . . 'matters as to which judicial notice may be taken . . . .' ") (*quoting Brass*, 987 F.2d at 150); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1092 (2d Cir. 1995); *Allen v. Westpoint-Pepperell, Inc.*, 945 F.2d 40, 44 (2d Cir. 1991) ("In determining the adequacy of a claim under Rule 12(b)(6), consideration is limited to facts stated on the face of the complaint, in documents appended to the complaint or incorporated in the complaint by reference, and matters of which judicial notice may be taken."); *Kramer*, 937 F.2d at 774.

Appendix C

PROLOGUE

The two cases before the Court are part of a large group assigned to this Court by the Multidistrict Panel for consolidated administration. These cases, and the New York Attorney General's report which precipitated them, brought to specific public attention certain aspects of the internal operations in securities firms that had notoriously and long existed and had been variously publicized but not focused on as undesirable conflicts that should be ameliorated, modified, conceivably controlled or eliminated.

Securities firms had traditionally employed on their rosters paid professional analysts to furnish their opinions and predictions of future targets of prices for the securities being handled by the firms, in effect "risk advisors." Those opinions and predictions were broadcast extensively and distributed free of charge. No customer relationship with defendants is claimed by the plaintiffs; no fiduciary or contractual relations existed, at least none is claimed.

Those analyst "seers" and their employers have been faulted in the present cases with having conflicting self-interests which influenced and impaired the publicized advice and opinions by exhortations of "BUY" advice and "Target" expectations to market speculators in the then popular internet field.

At the times here involved, the stock markets were in the throes of a colossal "bubble" of panic proportions. Speculators abounded to capitalize on the opportunities presented by this bubble.

Appendix C

The market "bubble" burst intervened before plaintiffs got out of their holdings and their holdings lost value. The plaintiffs, learning of the subsequent actions of the regulators concerning the conflicts mentioned above, rushed to the courts in these cases seeking to recover the losses they experienced due to the intervening cause, the burst of the bubble.

The companies involved herein were duly registered with the SEC. Their assets, liabilities and economics were there disclosed for any holder or purchaser including these plaintiffs to evaluate at his own risk. What was missing, was what a willing buyer would pay to a willing seller to own the stock-with all the relevant information of the fully published underlying corporate values there for everyone to see and evaluate.

In the euphoric early phase of the bubble experienced by the market buyers of stock traded in the optimistic expectation of finding someone who valued acquiring and possessing the stock at a level higher than the holder did even if some of the risk analysts of the stock privately had doubts from time to time, on price, future market value, but not underlying assets.

The risk manager's forecasts on future price were both correct and incorrect depending on the timing of the mercury level in the market thermometer. "Buy" or "accumulate" opinion was an appraisal of the direction of the unsteady market fever. Those who listened to those prognostications were rewarded with huge paper profits if they cashed in– depending on the cycle of the bubble. Others missed out with the collapse of the fever.

Appendix C

OVERVIEW

The record clearly reveals that plaintiffs were among the high-risk speculators who, knowing full well or being properly chargeable with appreciation of the unjustifiable risks they were undertaking in the extremely volatile and highly untested stocks at issue, now hope to twist the federal securities laws into a scheme of cost-free speculators' insurance. Seeking to lay the blame for the enormous Internet Bubble solely at the feet of a single actor, Merrill Lynch, plaintiffs would have this Court conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining a freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches, but which delivered such riches to only a scant handful of lucky winners. Those few lucky winners, who are not before the Court, now hold the monies that the unlucky plaintiffs have lost–fair and square–and they will never return those monies to plaintiffs. Had plaintiffs themselves won the game instead of losing, they would have owed not a single penny of their winnings to those they left to hold the bag (or to defendants).

Notwithstanding this–the federal securities laws at issue here–only fault those who, *with intent to defraud*, make a *material* misrepresentation or omission of *fact* (not opinion) in connection with the purchase or sale of securities that *causes* a plaintiff's losses. Considering all of the facts and circumstances of the cases at bar, and accepting all of plaintiffs' voluminous, inflammatory and improperly generalized allegations as true, this Court is utterly unconvinced that the misrepresentations and omissions

alleged in the complaints have been sufficiently alleged to be cognizable misrepresentations and omissions made with the intent to defraud. Plaintiffs have failed to adequately plead that defendant and its former chief internet analyst *caused* their losses. The facts and circumstances fully within this Court's proper province to consider on a motion to dismiss show beyond doubt that plaintiffs brought their own losses upon themselves when they knowingly spun an extremely high-risk, high-stakes wheel of fortune.

FACTUAL BACKGROUND AND ALLEGATIONS

Defendant ML & Co. is a holding company through which defendant MLPF & S provides research, brokerage, and investment banking services. From February 1999 through December 2001, defendant Blodget was a first vice president of Merrill Lynch and its primary analyst for companies in the internet sector. During the putative class periods, Merrill Lynch issued research reports on a number of different internet companies, including 24/7 and Interliant. Many of these reports included analysts' opinions on whether investors should buy the stocks at issue.

Plaintiffs are those investors in 24/7 and Interliant stocks who, during the putative class periods, purchased shares in the respective companies and subsequently lost money.[14]

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14. The 24/7 and Interliant actions are two of the approximately 27 consolidated actions in this litigation. Each of the actions consolidates cases pertaining to a single issuing company (internet stock) or investment fund. The 25 actions that are not the subject of the instant motion are stayed pending resolution of the legal issues

(Cont'd)

Suing to recoup these losses, they allege that the predictions expressed in Merrill Lynch research reports caused their losses. Reliance is alleged through the fraud-on-the-market theory. None of the plaintiffs alleges actually to have seen or read the analyst reports themselves. Indeed, none of the plaintiffs claims to have been a customer of Merrill Lynch or to have purchased the securities through Merrill Lynch; all concede that they were non-client purchasers.[15]

Plaintiffs allege that the analyst opinions expressed in the research reports were materially misleading and violated Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission. In support of the fraud allegations, plaintiffs rely almost exclusively on, and quote heavily from, an affidavit prepared by Eric Dinallo of the New York State Attorney General's Office (Dinallo affidavit).[16] The affidavit, filed April 8, 2002–more than a year after the close of the two class periods–detailed the efforts of the New York Attorney General to investigate defendants' internet research group.

(Cont'd)

raised in the 24[7] and Interliant motions. The Court will determine at the appropriate time the applicability of the rulings in the present opinion to the remaining consolidated actions.

15 Clients of Merrill Lynch were, in most cases, subject to arbitration agreements.

16 Plaintiffs have incorporated the affidavit into their complaints by reference.

Appendix C

The Dinallo affidavit was offered in support of an application before the New York state courts for an order, pursuant to New York state law, requiring Merrill Lynch employees to turn over documents and give testimony in the Attorney General's continuing investigation into whether defendants violated New York state law. Soon after the affidavit became public, plaintiffs filed these federal class action suits (now consolidated before this Court) against defendants alleging violations of the federal securities laws, including the federal provisions mentioned above. The Dinallo affidavit notes that the state regulations pursuant to which the Attorney General proceeded impose entirely different legal requirements. "Unlike the federal securities laws," the affidavit states, "no purchase or sale of stock is required, nor are intent, reliance, or damages required elements of a violation."[17]

The research reports

The internet research group at Merrill Lynch prepared two main kinds of reports on the companies that they followed: (1) quarterly Sector Reports (or "Quarterly Handbooks") containing in-depth analyses of the industry and each company in the sector covered by Merrill Lynch, and (2) reports focusing on one particular company that took the form of comments, bulletins and notes, which were generally issued in response to news from the issuer or new developments or trends affecting the company that was the

17. Eric R. Dinallo, Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354, at p. 7.

subject of the report (hereinafter Company Reports).[18] These reports were sometimes just a few letter-sized, single-spaced pages in length, and other times were several pages or more in length.

The reports show that the internet issuer companies were the primary sources of information for the Merrill Lynch analysts in forming their opinions. Plaintiffs make no allegation that any of the company-related information relied on by the analysts in preparing the reports was in any way false, nor do they allege that the analysts made up facts or misrepresented facts about any of the companies in any of the reports. Rather, plaintiffs allege in the main that the analysts misrepresented their true opinions in the reports (viz., opinions as to whether the stocks should or should not be purchased at the relevant times) and did not disclose certain alleged conflicts of interest within the Merrill Lynch brokerage house. In their brief, plaintiffs also claim–as they must, if they are to have any hope of satisfying federal securities fraud pleading requirements–that their complaints adequately show that these alleged misrepresentations and nondisclosures were material, were made with scienter, were

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18. This information is clear from the face of the reports themselves, which are referred to in the complaints. The Court has reviewed the 247 research reports issued between September 8, 1998 and November 9, 2000, the Interliant research reports issued between August 4, 1999 and February 21, 2001, and the Sector Reports issued between April 5, 1999 and September 15, 2000. The Court may consider the reports and draw reasonable inferences from them, *see supra* notes 2, 10-11 and accompanying text, because they are the very data that plaintiffs allege was misleading, they are integral to the complaints, and they were known to or in their possession of plaintiffs and utilized in framing the complaints.

relied upon by them in making their purchases, and ultimately resulted in their losses.

There were approximately forty-four Company Reports issued (at irregular intervals) with respect to 24/7 Real Media, Inc. during the alleged 24/7 class period, which stretches from May 12, 1999 through November 9, 2000. There were approximately thirty-four Company Reports issued (also at irregular intervals) with respect to Interliant, Inc. during the alleged Interliant class period, which stretches from August 4, 1999 through February 20, 2001.

The analyst reports discussed the companies' financial reports and revenue information, their respective business models and strategy, and the issuers' own estimates of future performance.[19] The reports frequently contained a description of the analysts' opinions as to the company's competitive position in the industry, including evaluations of comparable companies. In addition, the reports included the analysts' financial models and projections for the companies, evaluations of past company performance against such models and projections, as well as discussion of estimates and projections by other analysts. All told, these evaluations–none of which are alleged to be false or misleading in their factual underpinnings or in their methodology–provided background and support for the analysts' opinions on whether the individual stocks might be considered for purchases or for sales.

19. Some of the reports discuss similar research and projections by firms unaffiliated with Merrill Lynch's internet research group.

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Each of the company-specific research reports about which the 24/7 and Interliant plaintiffs complain carried a rating consisting of a two-part designation: (1) a letter (either A, B, C, or D) representing the analysts' opinion of the stock's "Investment Risk Rating," coupled with (2) a pair of numbers (each a numeral between 1 and 5) designating the analysts' opinion of the "Appreciation Potential" of the stock over time.

An Investment Risk Rating of "A" denoted the lowest level of risk. A stock with an "A" rating was expected to exhibit "modest price volatility," and typically represented a company with strong balance sheets, demonstrated long-term profitability, and "stable to rising dividends." A "B" rating meant that the stock was "expected to entail price risk similar to the market as a whole," and represented a company that had "demonstrated the ability to produce above-average sales, profits and other measures of leadership within its industry." A "C" rating indicated "above average risk," and represented companies with balance sheets that were average or below average for their respective industries. The "C" companies in many cases were new to the industry or had erratic earnings.

A "D" rating, which the analysts assigned to all Internet companies including 24/7 and Interliant, denoted the highest level of risk. In addition to having all of the characteristics of a "C" issuer, "D" companies were so designated because of the analysts' opinion that the company's stock had a "high potential for price volatility." One or more of the following factors, among others, could have led to a company's

receiving a "D" rating: untested management, lack of earnings history, or heavy dependence upon one product or service.

As noted above, the Investment Risk Rating for each stock was coupled with a pair of numbers. The two numbers, each a single digit between one and five, represented the analysts' opinions of the stock's Appreciation Potential. The first digit reflected the analyst's prediction of how the stock would perform over the short term, *i.e.*, within 0-12 months, and the second digit represented the analyst's prediction of performance over the intermediate term, *i.e.*, 12-24 months. The digits signified the following estimates:

1 BUY: Issue was considered to have particularly attractive potential for appreciation and was estimated to appreciate by 20% or more within the given time frame.

2 ACCUMULATE: Issue was considered to have attractive potential for appreciation and was estimated to appreciate by 10-20% within the given time frame.

3 NEUTRAL: Issue was considered to have *limited potential* for appreciation and was estimated to appreciate/decline by 10% or less within the given time frame.

4 REDUCE: Issue was considered too unattractive for appreciation and was estimated to decline by 10%-20% within the given time frame.

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5 SELL: Issue was considered to be particularly unattractive for appreciation and was estimated to decline by 20% or more within the given time frame.

Thus, a rating of **D-1-2** meant that the stock at issue was highly volatile and *estimated* to appreciate by 20% or more within the immediately following 12 months and 10-20% for the 12 months following that (i.e. the period stretching 12-24 months after issuance of the report).

I. PLEADING SECURITIES FRAUD

To recover damages in a private cause of action under Rule 10b-5, a plaintiff must plead and prove–among other elements–loss causation. "To establish loss causation a plaintiff must show[ ] that the economic harm that it suffered occurred as a result of the alleged misrepresentations." *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992) (emphasis in original).

1. Loss causation is missing from plaintiffs' pleadings

"Loss causation developed exclusively out of case law and was never expressly recognized by the Supreme Court."[20] In the Private Securities Litigation Reform Act of 1995

20. David S. Escoffery, Note, A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 68 Fordham L.Rev. 1781, 1781 (2000).

(Reform Act),[21] however, Congress codified a uniform loss causation standard and made it applicable to all securities fraud suits of the kind presently before the Court. To cope with the the scandals associated with such class suits, Congress enacted the so-called "Loss Causation" provision:

> (4) Loss causation
>
> In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.[22]

This was necessary in the Reform Act for the goal entitled in the legislation:

> **TITLE 1–REDUCTION OF ABUSIVE LITIGATION**
>
> **SEC.101. PRIVATE SECURITIES LITIGATION REFORM.**

Plaintiffs were explicitly reminded in this Court's Case Management Order No. 3, well prior to framing the allegations in the consolidated amended complaints, that they should give careful attention to pleading loss causation:

> Consolidated amended complaints should also be carefully framed in order that they may fully

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21. 15 U.S.C. § 78u-4.

22. 15 U.S.C. § 78u-4(b)(4).

comply with all applicable law regarding the pleading of loss causation.

Plaintiffs have failed to heed this reminder.

Plaintiffs claim in their brief that "[s]ome, and perhaps much, of the 'Internet bubble' was a classic stock market manipulation engineered by Wall Street's investment bankers and research analysts."[23] There is no factual predicate or legitimate inference from facts alleged in the consolidated complaint for plaintiffs' semantic invention of a stock market manipulation for internet company securities engineered by Wall Street's investment bankers and research analysts. Not even the freewheeling investigation and report make any such assertion or suggestion as a prop for its criticisms.

The cited alleged omissions of conflicts of interest could not have caused the loss of market value. The alleged omissions are not the 'legal cause' of the plaintiff's losses. There was no causal connection between the burst of the bubble and the alleged omissions; it was the burst which caused the market drop and the resultant losses a considerable time thereafter when plaintiffs decided it was time to sell. A defendant does not become an insurer against an intervening cause unrelated to the acquisition, e.g., a precipitous price decline caused by a market crash. The plaintiffs controlled their ultimate exit from the stocks after waiting no doubt for a market reversal.

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23. Opposition brief at p. 1.

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There are simply no allegations in the complaints, much less particularized allegations of fact, from which this Court could conclude that it was foreseeable that the alleged non-disclosures of conflicts would cause the harm allegedly suffered by plaintiffs as a result of the bursting of the Internet bubble. Plaintiffs have also failed to allege facts which, if accepted as true, would establish that the decline in the prices of 24/7 and Interliant stock (their claimed losses) was caused by any or all of the alleged omissions from the analyst reports.

Moreover, none of the Second Circuit cases upon which plaintiffs rely have applied the so-called "disparity of investment quality" or "price inflation" theory of pleading loss causation to a putative securities class action in which the plaintiffs sought to utilize the fraud on the market theory. Rather, each involved a face-to-face transaction in which the identified plaintiffs alleged that they actually detrimentally relied on defendants' misrepresentations and that they were harmed as a result. For sound policy reasons discussed below, plaintiffs' theory on loss causation should not be expanded to fraud on the market cases, where reliance is presumed (if certain criteria are met) based upon the assumption that in an efficient market "most publicly available information is reflected in market price, [and] an investor's reliance on any public material misrepresentation, therefore, may be presumed." *Basic v. Levinson*, 485 U.S. 224, 241-42 (1988).[24] In the circumstances here presented, the sound reasoning of the Eleventh Circuit Court of Appeals in *Robbins v. Koger*

24. As noted in Merrill Lynch's opening brief, plaintiffs allege that the fraud on the market theory applies in this case and that allegation is accepted as true solely for purposes of this motion.

Props., Inc., 116 F.3d 1441 (11th Cir. 1997), should be applied. There, the court observed that in a fraud on the market putative class action, price inflation is typically used as a surrogate for reliance and the closely related concept of *transaction* causation. After examining the concept of proximate causation carefully, the court reasoned that price inflation should not be extended to satisfy the independent requirement to plead *loss* causation:

> Our cases have not utilized the [fraud on the market] theory to alter the loss causation requirement, and we refuse to do so here. Our decisions explicitly require proof of a causal connection between the misrepresentation and the investment's *subsequent decline in value*.

Robbins, 116 F.3d at 1448 (emphasis added).

Accordingly, the court stated that in the circumstances presented, the "showing of price inflation, however, does not satisfy the loss causation requirement" and would otherwise collapse transaction and loss causation, *see id.*, a result which even plaintiffs acknowledge would be at odds with Second Circuit law.

Even if there was a claim that the misconduct caused the purchase price of the stocks to be artificially inflated, plaintiffs have failed to allege facts (as opposed to legal conclusions) from which to infer that the alleged omissions were a substantial cause of any inflation. In their memorandum, plaintiffs refer to only eight of the over eighty research reports issued by Merrill Lynch on 24/7 and

Interliant during the putative class periods and allege that the respective stock prices rose in the days following the issuance of the research reports. Yet despite instances thereafter when prices dropped following reports, plaintiffs make no attempt in their pleadings to allege facts that would support their conclusion that any minor increases were caused by an analyst's rating as opposed to the numerous other factors, including previously non-public internal financial information released at virtually the same time by the companies themselves (or elsewhere in the analysts' reports), or even the effect of reports issued by other analysts.

(a) Merely Alleging "Artificial Inflation" is Not Sufficient To Satisfy Loss Causation

Causation under federal securities laws "is two pronged: a plaintiff must allege both transaction causation . . . *and loss causation* . . . ." *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001) (emphasis added). The loss causation inquiry must examine "how directly the subject of the fraudulent statement caused the loss, and whether the resulting loss was a foreseeable outcome of the fraudulent statement." *Id.* at 96 (*citing First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994)). As explained in *AUSA Life Insurance Co. v. Ernst & Young*, the "foreseeability query" is whether the defendant could have reasonably foreseen that its alleged misconduct could lead to the financial decline of the investments which led to the harm to the investors. *See AUSA*, 206 F.3d 202, 217 (2d Cir. 2000) ("The foreseeability query is whether E & Y could have reasonably foreseen that their certification of false financial information could lead to the demise of JWP, by

enabling JWP to make an acquisition that otherwise would have been subjected to higher scrutiny, which led to harm to the investors.").

Here, to the contrary, plaintiffs have not alleged that there was any link between the allegedly overly optimistic ratings and the financial troubles of 24/7 or Interliant that led to their financial demise in the wake of the bursting bubble, nor any facts demonstrating that they were the cause.[25] Nor do plaintiffs allege facts demonstrating that it was foreseeable that the allegedly overly optimistic ratings would lead to the financial demise of 24/7 or Interliant.

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25 In contrast to the allegations here, in *WorldCom* the plaintiffs alleged that the analyst, among other things, was aware of and concealed the alleged accounting irregularities that directly led to the losses incurred by plaintiffs. Also, unlike here, plaintiffs alleged in *WorldCom* that the research reports were materially false and misleading because the analyst had failed to disclose material nonpublic information he possessed about the company and had purportedly concealed the company's true financial condition by employing a valuation model not used for any other company to allegedly disguise various aspects of the company's alleged "capital expenditure fraud." *See In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288(DLC), 2003 WL 21219049, at *9, *29 (S.D.N.Y. May 19, 2003). The *WorldCom* plaintiffs additionally alleged various undisclosed financial arrangements between the issuer and the analyst's firm. *See id.* at *10, *29-30. The complaints at issue here allege neither that Merrill Lynch possessed material nonpublic information regarding the financial condition of 24/7 or Interliant, nor the existence of any such undisclosed financial arrangements. The Court respectfully submits that the *WorldCom* decision is not broad enough to cover the allegations here.

(b) The Burst of the Bubble–Intervening Cause

The Second Circuit has also continued to stress the need to examine whether intervening causes are present and the lapse of time between the fraudulent statement and the loss. Both of these elements focus on conduct occurring *after* the investment decision and *after* the purchase of shares at the allegedly inflated price. For example, the Second Circuit reiterated in *Castellano v. Young & Rubicam, Inc.* that " 'when factors other than the defendant's fraud are an intervening direct cause of a plaintiff's injury, that same injury cannot be said to have occurred by reason of the defendant's actions.' " 257 F.3d 171, 189 (2d Cir. 2001) (citing *First Nationwide*, 27 F.3d at 769); *see also Suez Equity*, 250 F.3d at 96. As the Second Circuit explained:

> The cases where we have held that intervening direct causes preclude a finding of loss causation present facts sharply different from those at issue here [in *Castellano*]. *See Powers [v. British Vita*, 57 F.3d 176, 189 (2d Cir. 1995)] (market value of stock fell as a result of recession); [*First Nationwide*], 27 F.3d at 772 (investor's loss caused by marketwide real estate crash); *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992) (loss to plaintiff from loans made on the basis of fraudulent misrepresentation were the result of a decline in value of collateral unrelated to the fraud); *Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 62 (2d Cir. 1985) (loss caused not by misrepresentations in various documents used to attract investments but by

looting and mismanagement of these funds by controlling stockholders).

Castellano, 257 F.3d at 189-90. These cases distinguished by *Castellano* are plainly applicable to the facts here where the overall Internet market had collapsed–causing the price of 24/7 and Interliant to decline dramatically–and where plaintiffs cannot allege a factual link between that decline and defendants' conduct. Yet if merely alleging artificial inflation was sufficient, then there would be no need for any of these cases to discuss the importance of considering whether there was the presence of any intervening factors.

Indeed, the Second Circuit has held that "when the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases." *First Nationwide*, 27 F.3d at 772 (citing *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 684 (7th Cir. 1990)). Yet, plaintiffs' allegations utterly fail to take into account the intervening cause of the Internet market collapse.[26]

(c) Disparity in Price Theory is Inapplicable

Unlike the instant case, the Second Circuit cases upon which plaintiffs rely all involved face-to-face transactions

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26. In an attempt to distinguish *First Nationwide*, plaintiffs cite *AUSA*, for the uncontroverted proposition that *First Nationwide* "did not intend to bar a plaintiff from successfully pleading 'proximate cause when the claim follows a market collapse.' " Defendants did not argue that one could never plead proximate cause following a market collapse, but that plaintiffs have not done so.

and allegations of direct reliance on the allegedly false or misleading information.

"[T]he fraud on the market theory, as articulated by the Supreme Court, is used as a rebuttable presumption of reliance, not a presumption of causation." *See Robbins v. Kroger Props. Inc.*, 116 F.3d at 1448 (citing *Basic*, 485 U.S. at 241-42). To permit plaintiffs to allege artificial inflation through the fraud on the market theory to satisfy loss causation would improperly conflate both the "but for" transaction causation and the loss causation elements into one. The Eleventh Circuit in *Robbins* expressly rejected such an approach.

In *Robbins*, plaintiffs argued that the false financial statements misled investors about the ability of the issuer to sustain its high dividend level and, thereby, maintain an artificially inflated stock price. As evidence of the price inflation, plaintiffs alleged that "an adjustment in the stated amount of cash flow in July 1989, the beginning of the class period, would have required KPI to cut or eliminate its dividend, causing a $10.05 decline in KPI's stock price like the decline that occurred in October 1990." *Robbins*, 116 F.3d at 1446-47.

The Eleventh Circuit found that this was not enough to satisfy the loss causation requirement. *See id.*, 116 F.3d at 1448. The *Robbins* court concluded that the plaintiffs' actual loss was due to the decline in the price of their stock, which was caused by the company's cut in its dividend and not the fraudulent financial statements. The Eleventh Circuit rejected plaintiffs' attempt to satisfy loss causation by alleging,

through the fraud on market theory, simply that the price was artificially inflated:

> But the fraud on the market theory, as articulated by the Supreme Court, is used to support a rebuttable presumption of reliance, not a presumption of causation. *See Basic v. Levinson*, 485 U.S. 224, 241-42 (1988) ("Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action."). The theory was used for this purpose by the plaintiffs in this case. Because the theory supports a presumption of reliance, it is more closely related to the transaction causation requirement. Our cases have not utilized the theory to alter the loss causation requirement, and we refuse to do so here. Our decisions explicitly require proof of a causal connection between the misrepresentation and the investment's subsequent decline in value.

Robbins, 116 F.3d at 1448.

Plaintiffs' assertion that "[t]he *Suez Equity* test applied the fraud on the market theory to loss causation" is not correct. *Suez Equity* involved a claim of actual reliance in a face-to-face transaction and did *not* involve publicly traded securities or the fraud on the market theory.[27] On the other

27. Plaintiffs also cite to footnote 145 in Judge Scheindlin's over 100-page decision in *In re Initial Public Offering Securities* (Cont'd)

hand, in *Rothman v. Gregor*, 220 F.3d 81 (2d Cir. 2000), cited by plaintiffs, the Second Circuit analyzed loss causation in a fraud on the market case and examined whether the defendant could reasonably foresee that its alleged fraudulent failure to expense "would lead to a drop in GT's stock price." *Id.* at 95. Thus, the Second Circuit looked to whether that alleged misconduct caused the price to drop and did not analyze loss causation in terms of artificial inflation.[28]

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Litigation, 241 F. Supp. 2d 281 (S.D.N.Y. 2003). Judge Scheindlin recognized in the same footnote 145 that "[a]lthough the Second Circuit has never explicitly stated it that way; other circuits have." 241 F. Supp. 2d at 377-78 n. 145. The other circuit decision upon which she relied was the Ninth Circuit's decision in *Knapp v. Ernst & Whinney*, 90 F.3d 1431 (9th Cir. 1996), *see Robbins*, 116 F.3d at 1448, in which the Ninth Circuit collapsed transaction and loss causation and with which *Robbins* explicitly disagreed.

28. Allowing plaintiffs in a fraud on the market case to satisfy loss causation simply by alleging that a misrepresentation caused the price to be artificially inflated without having to allege any link between the conduct and a decline in price would undoubtedly lead to speculative claims and procedural intractibility. After any drop in price–even if, as here, it is entirely unrelated to defendant's conduct –a subsequently dissatisfied investor would be able (with the benefit of hindsight) to point to any allegedly misleading positive statement issued by anyone (not just the issuer) and couple that with an allegation that the price of the security was inflated as a result to satisfy loss causation. To allow such a claim would invite self-serving testimony, strike suits and protracted discovery. "The issues would be hazy, the[ ] litigation protracted, and the[ ] resolution unreliable." *Grace v. Rosenstock*, 228 F.3d 40, 48 (2d Cir. 2000). The Second Circuit has held that it "would reject any theory of causation that raised such prospects." *Id.* (affirming dismissal after trial of section 10(b) claims on loss causation grounds).

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Plaintiffs' extensive reliance on *Marbury Management* is also misplaced. As Judge Jacobs explained in his concurrence in *AUSA*:

> In that case, the compelling facts were that Alfred Kohn, a broker-trainee but not yet a broker, repeatedly told the customers that he was a broker. *See id.* at 707. Believing that Kohn was a broker, the plaintiffs bought and held securities on his recommendation, only to incur losses on their purchases. *See id.* It was clear that if the plaintiffs had known what was concealed-that broker-trainee Kohn was not the licensed broker he claimed to be-they would have declined to purchase the securities recommended by Kohn, and certainly would have sold the securities when they began to lose value: "Kohn's statements by their nature induced both the purchase and the retention of the securities, the expertise implicit in Kohn's supposed status *overcoming plaintiffs' misgivings prompted by the market behavior of the securities.*" *Marbury Management*, 629 F.2d at 708 n. 2 (emphasis added).
>
> Though one can debate whether the circumstances that were said to be loss causation in *Marbury* amount to anything more than transaction causation, *Marbury* does not purport to change the rule-which we have consistently applied before and since-that a 10(b) claim cannot succeed unless loss causation is demonstrated.

AUSA, 206 F.3d at 227 (Jacobs, J., concurring).

In short, *Marbury Management* is a unique fact pattern involving allegations of a direct misrepresentation and actual reliance and should not be extended to the allegations here, especially where plaintiffs here invoke the presumptions of fraud on the market theory. As Judge Meskill noted in his eloquent dissent there, the majority "strain[ed] to reach a sympathetic result" and improperly extended the reach of Section 10(b) even in a face-to-face transaction. *See Marbury*, 629 F.2d at 716-17 (Meskill, J., dissenting). Similarly, Judge Jacobs, in his concurrence in *AUSA*, also warned that "it would be a mistake to treat the *Marbury* facts as a template for loss causation;" that its holding should be limited to "the same set of facts;" and the Second Circuit "has never read *Marbury* to hold that transaction causation subsumes loss causation." *AUSA*, 206 F.3d at 227.

Since *Suez Equity*, courts in this district have rejected bare allegations that the misconduct alleged induced a disparity between the transaction price and "true investment quality" in the absence of specific facts connecting plaintiffs' losses to the misrepresentation alleged. *See Spencer Trask Software & Info. Servs. LLC v. RPost Int'l Ltd.*, 02 Civ. 1276(PKL), 2003 WL 169801, at *21 (S.D.N.Y. Jan. 24, 2003) (Leisure, J.); *see also Greenwald v. Orb Communications & Mktg., Inc.*, No. 00 Civ.1939 (LTS HBP), 2003 WL 660844, at *2 (S.D.N.Y. Feb. 27, 2003) (Swain, J.) (denying motion for reconsideration, rejecting plaintiff's contention that under *Castellano*, he had sufficiently alleged loss causation because he alleged " 'that defendant's misrepresentations induced a disparity between the transaction price and the true 'investment quality' of the securities at the time of the transaction' ") (quoting

Castellano, 257 F.3d at 188). Judge Sweet's decision in *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 195 F. Supp. 2d 551, 559-60 (S.D.N.Y. 2002), did not change his original analysis in his first decision dismissing the complaint for failing to allege loss causation even where defendants were alleged to have contributed to the bubble. *See Emergent*, 165 F. Supp. 2d 615 (S.D.N.Y. 2001). In the second decision, Judge Sweet still dismissed the complaint on other grounds, but found in *dicta* that – unlike here – plaintiffs amended their complaint to add specific allegations (not present here) that defendants in a face-to-face transaction made misrepresentations concerning non-public information about the qualifications and background of an insider to satisfy their burden of pleading loss causation. *See Emergent Capital Inv. Mgmt.*, 195 F. Supp. 2d 551.

By citing just eight reports, plaintiffs apparently are conceding that they have not alleged that any of the other over 75 research reports substantially caused any artificial inflation.[29]

Plaintiffs make no attempt to address any of the concerns raised in *First Nationwide*, in terms of alleging that it was

29. Under plaintiffs' theory, they must allege that each of the challenged ratings was the substantial cause of artificial inflation. Plaintiffs' complaints challenge every report over an approximate two-year period, yet there are no other allegations of loss causation regarding the other research reports. Furthermore, the lead and named plaintiffs do not allege that their losses are even linked to the inflation allegedly caused by any of these eight specified reports. For example, not one of the named plaintiffs purchased shares within the same month of any of these eight reports. (*Compare* Interliant Plaintiffs and 24/7 Plaintiff Certifications, *with* Pls. Mem. at 30.)

actually the alleged optimistic ratings – as opposed to other external factors – that was a substantial cause of the artificial inflation. For example, plaintiffs do not address that these eight research reports were issued on the same day that the issuer announced positive news (previously nonpublic information) about itself. (*See, e.g.*, Musoff Decl. Ex. 1, Comment dated Aug. 12 1999, at 1 ("24/7 Media reported a very strong Q2. . . . Q2 revenues increased 50% sequentially to $17.2 million. . . ."); Ex.2. Bulletin dated Nov. 17, 1999 at 1 ("Interliant announced the acquisition of Triumph Technologies, a private Internet security firm.").)

Plaintiffs also do not bother to differentiate between the ratings and the rest of the information in the research reports. These research reports themselves contained not only the issuers' news, but also a host of other factual information which is not being challenged here. (*See, e.g.*, Musoff Decl. Ex. 1, Comment dated Dec. 9, 1999, at 1 ("24/7 Media announced that its email division has increased its total number of opt-in email names to 15.5mm, up from 13mm at the end of Q3."); Ex. 2, Bulletin dated Feb. 1, 2000, at 1 ("Interliant preannounced 4Q99 results, ahead of expectations. Revenues of $18 million were 12% ahead of our $16.1 million estimate.").)[30]

30. In an attempt to overcome these defects, plaintiffs cite in their complaints several articles which discuss Mr. Blodget's alleged influence on the market. As an initial matter, these articles cannot replace allegations of actual artificial inflation. None of these articles ever state that it is the ratings, as opposed to his analysis in the research reports of the financial information provided by the company, that allegedly caused his influence. More significantly, none of the articles state that he had any impact on the price of 24/7 or

(Cont'd)

2. Plaintiffs fail to plead fraud with particularity

When, as here, a complaint contains allegations of fraud, Federal Rule of Civil Procedure 9(b) requires that "the circumstances constituting fraud . . . be stated with particularity." The Second Circuit has interpreted this language to mean that, in the securities fraud context, "the actual fraudulent *statements or conduct* and the fraud alleged *must be stated with particularity* . . . ."[31] The Second Circuit has held that, at a minimum, the complaint must identify the statements plaintiff asserts were fraudulent and why, in plaintiff's view, they were fraudulent–specifying who made them and where and when they were made.[32] This heightened particularity standard is reinforced by the Reform Act, in which Congress required that plaintiffs alleging material misrepresentations or omissions must "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading."[33]

(Cont'd)

Interliant. Indeed, as the analyst reports about which plaintiffs complain themselves reflect, Mr. Blodget did not even cover Interliant after February 2000, yet the putative class period runs until February 2001.

31 *Chill v. General Electric Co.*, 101 F.3d 263, 267 (2d Cir. 1996) (citing *Gold v. Morrison-Knudsen Co.*, 68 F.3d 1475, 1476-77 (2d Cir. 1995); *Acito v. IMCERA Grp., Inc.*, 47 F.3d 47, 51 (2d Cir. 1995); *Cohen v. Koenig*, 25 F.3d 1168, 1173 (2d Cir. 1994)) (underlined emphasis supplied).

32 *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993).

33 15 U.S.C. § 78u-4(b)(1).

Appendix C

(a) Plaintiffs fail to identify the precise misrepresentations and omissions alleged in 24/7 and Interliant

As noted above, plaintiffs must allege *with particularity*, and not in general terms, the statements or omissions that they contend were fraudulent, as well as the fraud itself.[34] It has not been an easy task to comb through the two prolix and unnecessarily repetitive complaints–each of which is 68 pages in length and lists over 180 numbered paragraphs containing much in the way of speculation and news reports–in search of precisely *what* the plaintiffs actually allege was materially misrepresented or omitted by defendants.[35] Indeed, there seems to be not insignificant grounds for finding the complaints in violation of Rules 8(a)(2) & (e)(2) of the Federal Rules of Civil Procedure. Defendants have moved to strike, and not without reasonable basis, paragraphs 13-18, 32, 36-37, 59-60, 62-64, 66-73, 82, 87-91, and 96-100 of the 24/7 complaint and paragraphs 4-9, 38-39, 61-62, 64-66, 68-74, 82, 87- 91, and 96-100 of the Interliant complaint as immaterial under Rule 12(f). Given that more than a dozen plaintiffs' firms had already had the benefit of nearly a year from the publication of the Dinallo affidavit in which to sharpen their allegations and hone their complaints,[36] the

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34. *See supra* notes 31-32 and accompanying text.

35. The other 25-odd consolidated amended complaints are similarly verbose.

36. The consolidated amended complaints were due March 14, 2003; twelve plaintiffs' firms shared the drafting responsibilities as lead counsel on various consolidated actions, with support from other firms.

Court had ample reason to consider, and did consider, simply dismissing the consolidated amended complaints outright with leave to re-plead again, this time in full compliance with the aforementioned Rules. This course of action would have laid the pleading burden squarely back where it belonged–with plaintiffs' counsel–and would have, hopefully, resulted in a set of complaints that was more manageable and more in compliance with the Rules.

Willing to give plaintiffs every benefit of any doubt, however, and attempting to keep delays, costs and attorneys' fees at reasonable levels, and mindful of its obligation to construe pleadings so as to do substantial justice,[37] the Court instead decided to shoulder, itself, the burden of threshing all of the chaff in search of any kernels that might emerge from the complaints.

After reading through many pages of allegations that are not always linked with the tightest of logical rigor, a reader of the 24/7 complaint comes upon the tersest statement of the material misstatement omission claim. In substance, the claim is as follows (bold emphasis supplied):

> "Defendants' misrepresentations and omissions **concerned**, *inter alia* . . . the fact that . . . :"
>
> (1) "[T]he [research reports'] ratings **in many cases** did not reflect the analysts' true opinions of the companies, including 24/7 Media."

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37 *See* Fed. R. Civ. P. 8(f).

(2) "[A]s a matter of **undisclosed**, internal policy, no 'reduce' or 'sell' recommendations were issued, thereby converting a published five-point rating scale into a *de facto* three-point system."

(3) "[Defendants] failed to disclose that Merrill Lynch's ratings were **tarnished** by an **undisclosed** conflict of interest in that the research analysts were acting as quasi-investment bankers for the companies at issue, often initiating, continuing, and/or manipulating research coverage for the purpose of attracting and keeping **investment banking clients**, thereby producing **misleading ratings** that were neither objective nor independent, as they purported to be."

(4) "[Defendants] failed to comply with the rules and regulations of the SEC, NASD and other regulatory authorities regarding communications to the investing public."[38]

Plaintiffs are tarring with a broad brush here the very action prohibited by, among other things, Rule 9(b) and the Reform

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38. 24/7 Compl. ¶ 173. The Interliant complaint (at ¶ 173) contains virtually identical, word-for-word allegations. For this reason, the ensuing analysis applies to the Interliant complaint with equal force.

Act, as set forth in detail above.[39] These provisions mandate a school of realism, not impressionism. Plaintiffs must set forth *with particularity each* statement they assert was fraudulent and why, in their view, the statement was fraudulent-specifying who made it and where and when it was made.[40] Moreover, the Reform Act mandates that plaintiffs specifically identify "*each statement* " alleged to be misleading *and* the reason or reasons why it is misleading.[41]

The complaints fail to meet those standards here. For example, in paragraph (1) above, the complaint alleges in a very generalized fashion that certain unspecified misrepresentations (plural) "concerned" various and sundry "ratings" that "in many cases" (it is not alleged how many) did not reflect "the analysts' " opinions of "the companies," "including 24/7 Media." The specifics, which must be alleged if the claims are to meet the particularity standards of Rule 9(b) and the Reform Act, are hidden from view. Nowhere here is it alleged with particularity which statements–i.e. specifically *which* statements in specifically *which* of the *forty-four* 24/7 research reports published during the class period–carried "not true" opinions, or how these "misrepresentations" (plural) "concerned" the various "companies," or any of the specific facts upon which the belief that the opinions (whichever ones are meant) were false

39. See supra notes 7-8, 31-33 and accompanying text.

40. See supra notes 7, 31-32 and accompanying text.

41. See supra notes 8, 33 and accompanying text.

is based, or precisely when or where the statements were made (i.e. again, specifically which statements, in specifically which of the 24/7 research reports, released at specifically which times). The absence of these particularized allegations is all the more telling given that plaintiffs had eleven months of access to the Dinallo affidavit (and other materials), which collected and quoted portions of the then-30,000-document, 100,000-page, 20-deposition, "thousands-of-emails" *ex parte* regulatory investigation.[42] The fact that plaintiffs apparently could find nothing more tangible and specific to allege about the 24/7 reports from this voluminous windfall of material (*i.e.*, nothing more specific to bolster the allegations in the paragraphs noted above–and most securities fraud plaintiffs have much less material to draw upon–is an early signal that the complaints are straining to meet the pleading burden.

A close examination of the allegations set forth in paragraphs (2), (3), and (4) above yields similar results. Although plaintiffs do not specify whether paragraphs (2), (3), and (4) concern omissions or affirmative misrepresentations, and do not specifically identify the omissions or affirmative misrepresentations in any event, the Court, attempting to give the fairest reading possible, interprets the allegations in paragraphs (2), (3), and (4) to involve omissions (and not affirmative misrepresentations), whose specificity unfortunately must be gleaned and stitched together laboriously from disparate elements of the preceding 172 paragraphs of the complaint–a task that plaintiffs were under an obligation to do themselves.

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42. Dinallo affidavit at p. 2.

Appendix C

For now, it should be noted that, as in paragraph (1), the allegations in paragraphs (2), (3), and (4) fail to meet the applicable particularity standards. The claims are dotted with generalities. First, the allegations in paragraphs (2) through (4) do not specify which of the two categories–affirmative misrepresentations or omissions–are involved. Second, assuming that omissions are what are characterized here, plaintiffs fail to specify the reason or reasons *why* the existence of the omissions meant that the research reports (and again, it is not alleged which of the forty-four 24/7 research reports are involved) were misleading.[43] Nowhere in these paragraphs is it specifically alleged precisely *which* analysts had *which* conflicts of interest involving *which* investment banking deals leading to *which* 24/7 research reports being misleading, to what degree, and when. Instead the complaints allege that "analysts" (in general) were "often" (no specifics) "initiating, continuing and/or manipulating" (note the vague catchall conjunction "and/or") "research coverage" (in general), producing generally "misleading ratings" (no specifics or reasons given) that were generally "tarnished" (plaintiffs should allege whether "tarnished" encompasses "materially misleading," and if so, how) all in order to attract and keep various unnamed and unspecified investment banking "clients." The extensive use of generalized plural nouns ("misrepresentations and omissions," "clients," "ratings," "rules and regulations," "analysts," "opinions," "companies," "quasi-investment bankers"), combined with the use of vague modifiers ("often," "concerning," "in many cases," "and/or," "*inter*

43. See supra notes 7-8, 31-33 and accompanying text for the applicable legal requirements.

alia") and a marked absence of named particulars are a dead giveaway that the complaints are skirting the pleading requirements imposed by Rule 9(b), the Reform Act, and the law of the Circuit.

In sum, Rule 8(a)(2) requires that complaints contain a "*short and plain* statement of the claim showing that the pleader is entitled to relief" (emphasis supplied). In each of the complaints at bar, however, the statement of the claim appears to be scattered throughout a voluminous 68-page document. Moreover, as shown in the discussion above, even in the paragraphs in which the complaints finally set forth the claims in something other than verbose terms, the allegations turn out to be vague and elusive.

Plaintiffs were explicitly reminded in Case Management Order No. 3, well prior to the filing of their consolidated amended complaints, that they should take special care to comply with the particularized pleading requirements:

> *Each counsel who has been appointed Lead Counsel in a particular consolidated action is responsible for obtaining the necessary information such that the consolidated amended complaint filed for that case will comply with the pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure and the PSLRA, in particular 15 U.S.C. § 78u-4(b)(1) & (2). The factual allegations must be specific to the security in question and should clearly allege who said what to whom concerning that particular security.*

Plaintiffs have failed to heed this reminder, making it very difficult for a court to make the necessary analysis of, among other things, the *materiality* (which necessarily depends on all relevant circumstances and the total mix of information available to the reasonable investor at the time of each alleged misrepresentation or omission) of the alleged misrepresentations and omissions.

(b) Plaintiffs Fail To Address the Pleading Requirements Applicable to Statements of Opinion

Plaintiffs do not dispute that under *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1095-96 (1991), the only challenge that may be made to a statement of opinion is that the speaker did not actually hold the opinion; undisclosed motivations are not actionable. Indeed, plaintiffs fail to even mention the Supreme Court decision in their papers. Plaintiffs effectively also concede that for pleading purposes, they must allege particular facts, *for each and every rating challenged*, that Merrill Lynch and Mr. Blodget did not hold the opinion or had no reasonable basis for believing the opinion.[44]

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44 Although they set up a strawman argument Merrill Lynch never made—that "statements of opinion are not actionable"—plaintiffs note that statements of opinion may be actionable if they "'are supported by specific statements of fact [that are false], or if the speaker does not genuinely or reasonably believe them.'" (Pls. Mem. at 41 (quoting *In re IBM Corp. Sec. Litig.*, 163 F.3d 102, 107 (2d Cir. 1998)).) Although plaintiffs conclusorily allege that defendants "did not genuinely or reasonably believe [the ratings]" (Pls. Mem. at 46–47), they do not allege contemporaneous facts to show the falsity of each and every research report according to this standard.

(Pls. Mem. at 69-70.) Yet they assert, without any citation to authority, that the alleged subjective motive to garner investment banking fees from 24/7 and Interliant provides such a basis. (Pls. Mem. at 72-73.) Because, as plaintiffs concede, the ratings are beliefs or opinions (Pls. Mem. at 40-42), plaintiffs' theory is not legally viable. *See Bond Opportunity Fund*, No. 99 Civ. 11074 (JSM), 2003 WL 21058251, at *5 (S.D.N.Y. May 9, 2003) (plaintiff must allege speaker "did not actually hold the belief or opinion stated, *and* that the opinion stated was in fact incorrect" (citing *Virginia Bankshares*, 501 U.S. at 1093-98)).[45]

Allegations regarding the motivation to attract investment banking business are not specific contemporaneous data or information inconsistent with the opinions. *See In re IBM Sec. Litig.*, 163 F.3d at 107; *Faulkner*, 156 F. Supp. 2d at 397-99.[46] Although plaintiffs acknowledge that *Faulkner* and *IBM* set forth the standards applicable to pleading a claim based upon an allegedly false statement of opinion (Pls. Mem. at

45. Plaintiffs allege that the Dinallo Affidavit "established" that "[all] Analyst Reports that Merrill Lynch issued on Internet companies were false and misleading because the opinions . . . were *not necessarily* . . . true." (24/7 Compl. ¶ 17; Interliant Compl. ¶ 8). It is not enough, however, to allege that statements "might have" been false.

46. *See also Rodman v. Grant Found.*, 608 F.2d 64, 71 (2d Cir. 1979) ("[T]he directors were not required to put forth in the proxy materials an analysis of their otherwise obvious interest in company control."); *Lewis v. Oppenheimer & Co.*, 481 F. Supp. 1199, 1204 (S.D.N.Y. 1979) (Pollack, J.) (stating that it is "well-established" that the securities laws are not concerned with "actual subjective motives," provided the "relevant underlying facts" are disclosed).

40-41 & n. 33), plaintiffs protest that the standards are unreasonable and essentially ask the Court to ignore them. (Pls. Mem. at 71.)[47] Without any citation to authority, plaintiffs assert that pleading "facts" relating to defendants' alleged motives to issue the reports are sufficient to plead that each particular rating was false. (*Id.*)

Plaintiffs confuse the inquiry as to whether they have pled facts with respect to motive and opportunity as it relates to the defendants' state of mind, *see* 15 U.S.C. § 78u4(b)(2), with the inquiry as to whether plaintiffs have sufficiently alleged that defendants made materially false statements, *see* 15 U.S.C. § 78u-4(b)(1). These are independent pleading requirements and the pleading of a motive to issue false statements does not establish that false statements were in fact issued. *Cf. San Leandro*, 75 F.3d at 813 ("Since plaintiffs have not alleged circumstances indicating that any of the statements identified in the Complaint were false, the plaintiffs have failed to adequately plead fraud.") (citing *Acito*

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47. Even plaintiffs' cases require that such a complaint allege with particularity knowledge of facts undermining defendants' statements or facts showing that defendants had no reasonable basis for the opinion expressed. *See, e.g., In re Nortel Networks Sec. Litig.*, 238 F. Supp. 2d 613, 627-28 (S.D.N.Y. 2003) (Berman, J.) (soft opinions sufficiently alleged to be false where plaintiffs pleaded specific facts to show that defendants could not possibly have believed opinion at time it was made); *Gabriel Capital, LP v. NatWest Fin., Inc.*, 122 F. Supp. 2d 407, 416, 419 (S.D.N.Y. 2000) (Scheindlin, J.) (plaintiffs adequately alleged statement not reasonably believed where defendant stated that mill was "first class" despite allegations that it had not verified design or operating assumptions and had repeatedly expressed "serious concerns" about it) (Pls. Mem. at 41-42).

v. IMCERA Group, Inc., 47 F.3d 47, 53 (2d Cir. 1995)). In this case, the pleading of a false statement does not "dovetail" with scienter as plaintiffs assert. (Pls. Mem. at 71.) Just last month, Judge Martin dismissed a complaint alleging a violation of Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), challenging statements of opinion in a proxy statement, holding that "absent impermissible speculation and extensive extrapolation as to defendants' purposes and motives, plaintiffs [had] not set forth sufficient facts" supporting plaintiffs' allegations that the proxy statements were false and misleading. *Bond Opportunity Fund*, 2003 WL 21058251, at *5.[48]

Because the issues of alleged "conflicts" and lack of sell ratings are irrelevant to the determination of whether the ratings were genuinely held beliefs, plaintiffs are left with just the e-mails. However, e-mails concerning securities other

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48. Plaintiffs' reliance on *Rothman v. Gregor*, 220 F.3d 81 (2d Cir. 2000) for the proposition that their allegations of falsity "satisfy the relevant pleading standard," is misplaced. There, the accounting violation alleged required knowledge that particular capital expenditures would not be recovered through future sales, *i.e.*, that write-offs were required, and plaintiffs alleged particular facts to support the allegation that the directors knew that the writeoffs would be necessary, but allowed the assets to remain on the books. *See id.* at 89-92. The court noted that the allegations supporting scienter, *i.e.*, that defendants knew or had concluded that they could not recoup the advances through future sales "essentially combines the misrepresentation and scienter inquiries." *Id.* at 90. *Rothman* certainly does not support plaintiffs' position here that by pleading a motive to issue false statements that they also have satisfied their burden to plead the falsity of the statement.

than 24/7 and Interliant fail to meet the Rule 9(b) (let alone the PSLRA) pleading requirements necessary to allege that Merrill Lynch made fraudulent statements in reports concerning 24/7 or Interliant. In *Stern v. Leucadia Nat'l Corp.*, 844 F.2d 997, 1003-04 (2d Cir. 1988), the Second Circuit rejected plaintiff's reliance on other instances in which "[defendant] assertedly obtained greenmail from other corporate targets" as insufficient under Rule 9(b) to support plaintiffs' allegations that the defendants' public filings in connection with yet another unconsummated merger were fraudulent because they, too, were allegedly part of defendants' alleged scheme to extract "greenmail" from the current failed merger candidate. *See id.* at 1003-04. "It is not enough to quote press speculation about defendants' motives and press reports of other occasions on which [defendant] assertedly obtained greenmail from other corporate targets. . . . Such allegations simply do not provide . . . 'specific, well-pleaded facts'. . . ." *Id.* at 1004.[49]

Moreover, the characterizations of snippets of e-mails and conclusions of the New York Attorney General,[50]

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49. *See also, e.g., W.E. Darin Constr. Enters. v. Detroit Coke Co.*, 814 F. Supp. 325, 331 (W.D.N.Y.1993) ("Other conclusory allegations in the complaint involving the relationships between McNamara and the other named Defendants, and unsubstantiated allegations that at least twelve other contractors have fallen victim to the same scheme, do not provide a factual basis for the inference that those Defendants used wires and mails 'for the purposes of executing such scheme or artifice . . . .' " (citation omitted)).

50. Without attempting to supply the context, plaintiffs quote the Dinallo Affidavit's characterization of an excerpt of an e-mail

(Cont'd)

submitted in a regulatory proceeding for an *ex parte* injunction, in addition to failing to constitute well-pleaded facts, are improperly included in plaintiffs' complaints.[51] Although plaintiffs assert that Merrill Lynch's motion to strike is "frivolous" (Pls. Mem. at 1 n. 2), and "should simply not be considered at this stage of the proceedings" (Pls. Mem. at 57 n. 50), plaintiffs fail to address, let alone distinguish, *Lipsky v. Commonwealth United Corp.*, 551 F.2d 887, 892-94 (2d Cir. 1976).

Without the legal conclusions of the Dinallo Affidavit and the e-mails concerning securities other than Interliant, the Interliant plaintiffs have no e-mails or any other contemporaneous facts concerning Interliant to attempt to explain why any rating on Interliant was not actually and reasonably believed at the time it was issued.[52] This obviously

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(Cont'd)
(which also omits the communications to which Mr. Blodget was responding) as "evidenc [ing] [that] . . . the treatment of Aether Systems" supports the conclusion that "the Internet Group rarely issued Analyst Reports that reflected their true opinions and were issued as part of the overall scheme to attract investment banking business." (24/7 Compl. ¶ 89; Interliant Compl. ¶ 89.) The 24/7 and Interliant complaints fail to explain how this e-mail renders any–let alone all–"Analyst Reports" on 24/7 or Interliant false and misleading.

51. *See Senders v. Morgan Stanley Dean Witter & Co.*, 01 Civ. 7621(MP), 2001 WL 958927, at *1 (S.D.N.Y. Aug. 21, 2001) (the views of politicians and their conclusions "may not properly be put on trial in this case").

52. Defendants have noted the plaintiffs' inappropriate allusion to other "evidence" they have in footnotes ten and sixty-three of (Cont'd)

does not meet the requirements of the Reform Act and Rule 9(b) to show that the analyst did not believe any particular rating.

The 24/7 plaintiffs do not fare any better. They cite two e-mails relating to 24/7, one dated March 6, 2000 and one dated October 10, 2000, but fail to explain why either of these e-mails renders any contemporaneous rating or report false. *See, e.g., Duncan v. Pencer*, No. 94 Civ. 0321, 1996 WL 19043, at *8 (S.D.N.Y. Jan. 18, 1996) (Preska, J.) (conducting statement by statement analysis and dismissing claims as to 27 of 30 statements).[53] Moreover, their complaint cannot possibly state claims with respect to opinions issued *before* March 6, 2000.

3. The Alleged Omissions Were Not a "Fraud on the Market"

The market could not have been defrauded by the alleged failure to disclose the conflicts or the supposed three-point rating system. Plaintiffs' own allegations and the articles upon which they rely evidence that the market was apprised of the

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(Cont'd)
their opposition memorandum. Surely plaintiffs are aware of the procedure for a motion to amend their complaints. They cannot hold such "evidence" back in the hopes of having yet a third bite of the proverbial apple.

53. Indeed, even the SEC and other regulatory agencies, which are not bound by the heightened pleading standards of the PSLRA, were not so audacious as to suggest—as plaintiffs do here—that *all* of the research reports were false and misleading.

very conflicts and ratings issues raised by them. The ratings and conflicts for all of the securities were known to the market and were specifically disclosed in the Sector Reports. *See* Musoff Decl. Exs. 1, 7, 8 (Internet Sector; Reset of Sector Ratings, August 7, 2000, at 2.); *see also, e.g.*, Ex. 3(d), at 11.[54]

4. Plaintiffs Cannot Avoid the Heightened Pleading Requirements Regarding The Alleged Misrepresentation and Omissions by Purporting To Assert 10b-5(a) & (c) Claims

Plaintiffs' contention that they "need not allege or prove that Defendants made any misrepresentations or omissions of material fact" to prevail on a 10b-5(a) or (c) claim is simply not true in this case where their claims are based *only* on alleged misrepresentations and omissions. As such, plaintiffs must comply with the pleading requirements of the Reform Act.

Plaintiffs ignore *Schnell v. Conseco, Inc.*, 43 F. Supp. 2d 438, 448 (S.D.N.Y. 1999) (Parker, J.) (describing claims

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54. Plaintiffs attack the description of the rating system set forth in the Dinallo Affidavit, stating that the "real" rating system was contained in a document that they now contend is not even referenced in their complaints. (Pls. Mem. at 43.) *See* Musoff Decl. Ex. 1, Internet Sector; Reset of Sector Ratings, August 7, 2000. In this Sector Report, Mr. Blodget explained that "[m]ost of the stocks at each rating have the following characteristics (we have made exceptions in some cases, with the reasons stated)." *Id.* at 2-4. Nowhere does he state that this is or ever was the basis for Merrill Lynch's ratings. In addition, the August 7, 2000 report shows that Mr. Blodget's group was not even rating Interliant at this time. *See id.* at 2.

relating to the issuance of misleading research reports, use of fictitious investor names to send false opinions, cold calls to investors and failure to inform the public of defendant's true stake in the alleged scheme), cited by Merrill Lynch, which directly rejected the tactic taken by plaintiffs here. Then-District Judge Parker held that because plaintiff's "market manipulation" claim was based on misrepresentations and omissions, plaintiffs claims were subject to the PSLRA's requirement that false statements and scienter be pleaded with particularity. *See id.*

Plaintiffs also ignore that, as explained by this Court, " '[m]anipulation is a term of art with a narrow definition.' " *Lewis v. Oppenheimer & Co.*, 481 F. Supp. 1199, 1202 n. 1 (S.D.N.Y. 1979) (Pollack, J.) (quoting *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 42 (1977)); *see also SEC v. Martino*, No. 93 CV 3446(MP), 2003 WL 1793027, *16 (S.D.N.Y. Apr. 2, 2003) (Pollack, J.) (describing various indicia of manipulation claims). Instead, plaintiffs rely on cases in which the alleged misrepresentations and omissions were but one piece of a larger alleged market manipulation scheme. *See In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 563-65 (S.D.Tex.2002);[55] *In re IPO Sec. Litig.*, 241 F. Supp. 2d at 293.

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55. The *Enron* decision contained a half page footnote describing different types of market manipulation claims. *In re Enron*, 235 F. Supp. 2d at 568 n. 8.

Appendix C

II. PLAINTIFFS DO NOT OVERCOME THE BESPEAKS CAUTION DOCTRINE

Plaintiffs first argue that the ratings are not entitled to the protection of the bespeaks caution doctrine because the statements are not forward looking. In support of their position, plaintiffs assert that the reports and ratings reflected, among other things, the current opinions of the analysts based on current qualities of the companies. This is incorrect. A recommendation to "buy" a stock is necessarily forward-looking because whether the stock price will appreciate is dependent on the unknowable variable of the future stock price. Moreover, plaintiffs' distinction is irrelevant because "mixed statements" consisting of forward looking and non-forward looking factors are nonetheless treated by courts as forward looking. *See Harris v. Ivax Corp.*, 182 F.3d 799, 806-07 (11th Cir. 1999) (holding that sections of the prospectus qualified as forward looking even though they also contained statements of current conditions).

Plaintiffs also argue that the cautionary statements published in the very research reports plaintiffs challenge were ineffective because plaintiffs suggest that Merrill Lynch knew all along "with near certainty that the Grand Canyon lies one foot away." Plaintiffs' " Grand Canyon" is the bursting of the Internet bubble and the concomitant dramatic drop in the stock price of Interliant and 24/7. While Merrill Lynch warned of the risks associated with investing in 24/7 and Interliant, including the weaknesses in the companies' fundamentals and the high volatility associated with the respective stock price, at bottom, there are no particularized allegations of fact in the complaints that, if accepted as true,

would (or could), demonstrate that Merrill Lynch knew "with near certainty" that 24/7's and Interliant's stock prices would not appreciate, e.g., by 10-20% within 12 months; that it could have predicted the date and dimensions of the Internet market collapse; and that it knew that the Internet market would not rebound as it had in the past.[56] Predictions of future trading prices in the stock market are inherently speculative. There are no allegations in the complaints to support an inference that Mr. Blodget–either on the basis of hard information or a crystal ball–could have predicted with certainty how the future stock prices of any stock would fluctuate.[57]

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56. Conclusory allegations that Merrill Lynch knew the reports and ratings were false when made are insufficient to render the bespeaks caution doctrine inapplicable. *See Spencer Trask Software & Info. Servs. v. RPost Int'l Ltd.*, No. 02 Civ. 1276(PKL), 2003 WL 169801, at * 22 n. 16 (S.D.N.Y. Jan. 24, 2003) (distinguishing cases in which plaintiffs "made factual allegations regarding the defendants' knowledge of information which would make the cautionary statements fraudulent," noting that the complaint made "no factual allegations regarding [defendant's] knowledge of any barricades or existing concerns . . . which would make the cautionary language fraudulent"); *see also In re Prudential Securities Inc. Ltd. Partnerships Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996) (plaintiffs identified specific information in defendants' possession that made the *cautionary statements* fraudulent).

57. Plaintiffs' assertions concerning Merrill Lynch's alleged motivations for issuing the reports–the purported undisclosed conflicts of interest and absence of sell recommendations–do *not* relate to the risks associated with the *stocks*. *See Halperin v. EBanker USA.com. Inc.*, 295 F.3d 352, 357 (2d Cir. 2002); *see also Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 8 (2d Cir. 1996). Accordingly, much of plaintiffs' argument simply misses the point.

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Plaintiffs also argue that the cautionary statements were nothing more than "boilerplate." (Pls. Mem. at 49.) This is belied by the specific risks outlined in the reports themselves. Blodget's opinions of the possible future stock performance were replete with risk warnings of the potential that the stock price could drop significantly and the reasons why this might happen. For example, Merrill Lynch warned:

> 24/7 and Interliant both carried a "D" rating, which was published on the first page of every report and signified that the stocks have *"high potential for price volatility"* (ML 02084-02085 (emphasis added).)
>
> In May 1999, the report warned of potential problems associated with 24/7 financial controls and that "[t]his makes *accurate forecast of results difficult."* (Musoff Decl. Ex. 1, Bulletin, dated May 1999, at 1 (emphasis added).)
>
> In August 1999, after 24/7 announced strong second quarter figures, the report warned on the first page that *"the stock is likely to be extremely volatile."* (Musoff Decl. Ex. 1, Comment, dated Aug. 12, 1999, at 1 (emphasis added).)
>
> Reports on Interliant expressly cautioned investors that "the stock's *valuation is aggressive* in light of the company's relatively early stage of development and the *risk associated with the consolidation strategy."* (Musoff Decl. Ex. 2, Comment dated Aug. 12, 1999, at 3 (emphasis

> added); *see also* Ex. 2, Comment dated Oct. 29, 1999, at 3.)
>
> Regarding Interliant, the report cautioned that "the market is still very nascent—even by Internet standards—and *we expect it to develop 'in fits and starts.'* " (Musoff Decl. Ex. 2, Bulletin, dated Feb. 1, 2000, at 1 (emphasis added).)
>
> Again in February 2000, the report warned that "the [Interliant] story still represents a work in process. . . . We continue to have *concerns about low revenue visibility and volatile margins.*" (Musoff Decl. Ex. 2, Comment dated Feb. 18, 2000, at 1 (emphasis added).)[58]

Merrill Lynch also repeatedly cautioned investors concerning the risks associated with 24/7 and, in particular, the 24/7 Connect ad-serving proprietary software which Mr. Blodget later described as a "pos." Indeed, this e-mail from October 2000–well after plaintiffs concede the Internet bubble burst–is the only contemporaneous fact that either plaintiff points to in support of their argument that Merrill Lynch's ratings on 24/7 and Interliant were false or not reasonably believed. This example fails.

Mr. Blodget's concern over the successful development, rollout and functioning of the 24/7 Connect proprietary

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58. All of these cautionary statements are taken from the research reports that plaintiffs allege are false and misleading. As set forth above, the Court may consider these documents for purposes of the instant motion as they are integral to the complaints.

software was evident from his first reports on the company and was frequently reiterated. In his May 1999 report reinstating coverage of 24/7, for example, he cautioned that "[t]he major risk to our [24/7] financial projections, in our opinion, concerns the successful, on-time launch of [24/7] newly renovated ad-servicing solution (expected in Q3)." (Musoff Decl. Ex. 1, Comment, dated May 12, 1999, at 2.) Mr. Blodget also consistently reminded investors that questions about "the rollout to 24/7 Connect remain[ed] an overhang on all of 24/7's businesses and the stock." (Musoff Decl. Ex. 1, Bulletin, Dated May 11, 2000, at 2; *see also* Ex. 1, Comment, dated March 13, 2000, at 2.) By August 2000, Blodget cautioned investors that "24/7 [had] not yet completed the full rollout of Connect, whose last target date was June 30." (Musoff Decl. Ex. 1, Bulletin, dated Aug. 10, 2000, at 1; *see also* Comment, dated Aug. 11, 2000, at 1.) These cautionary statements demonstrate that Blodget communicated to investors from his first report on 24/7 his concern that the 24/7 Connect product may not perform as well as the company projected.[59] Therefore, Blodget's casual

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59. Indeed, the securities laws do not require disclosure of any particular adjective when the overall message of caution is communicated to investors. *See Salinger v. Projectavision, Inc.*, 934 F. Supp. 1402, 1415 (S.D.N.Y. 1996) (defendants are not " 'required to characterize either possible results or their operations in a pejorative manner merely to cover all the bases should things turn out worse than expected' " (citation omitted)), complaint dismissed, 972 F. Supp. 222 (S.D.N.Y. 1997); *Rand v. Starter Corp.*, No. 94 Civ. 5325(DC), 1995 WL 322024, at *4 (S.D.N.Y. May 30, 1995); *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1277 (D.C.Cir. 1994) ("Since the use of a particular pejorative adjective will not alter the total mix of information available to the investing public . . . such statements are immaterial as a matter of law and cannot serve as the basis of a 10b-5 action under any theory.").

statement in October 2000 that the product was a "pos," cannot be construed as inconsistent with the total message of his reports that there were significant concerns about the rollout and functionality of the product which could have a dramatic impact on the 24/7 stock price.

III. PLAINTIFFS' CLAIMS ARE BARRED BY THE ONE-YEAR STATUTE OF LIMITATIONS

(1) Statute of Limitations is an Appropriate Ground to Consider on a Motion To Dismiss[60]

In an effort to avoid the dispositive reach of the statute of limitations, plaintiffs' primary argument is that dismissal on statute of limitations grounds "is only appropriate when all of the facts necessary for determination of the question of the timeliness of the filing of the complaint are set forth in the complaint or in a limited universe of documents that are integral to or cited in the complaint." This is squarely contrary to *LC Capital Partners, LP v. Frontier Ins. Group, Inc.*, 318 F.3d 148 (2d Cir. 2003). There, the Second Circuit affirmed the Rule 12(b)(6) dismissal of a putative securities class action because the plaintiffs were on inquiry notice of the claims more than one year prior to bringing the action as a result of a publicly available news article and another filed action.[61] *See id.* at 155. Courts in this district routinely dismiss

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60 Plaintiffs concede that the one-year statute of limitations applies. (Pls. Mem. at 54 n. 44.)

61 In *LC Capital*, the article was published in a more obscure source than the more mainstream publications at issue here, such as *The Wall Street Journal*, *Business Week* and *The Economist*.

securities fraud claims on statute of limitations grounds at the pleading stage where, as here, the facts necessary to trigger inquiry notice are apparent from the face of the complaint, the documents cited therein and other public documents.[62] *See Nairobi Holdings Ltd. v. Brown Bros. Harriman & Co.*, No. 02 Civ. 1230(LMM), 2003 WL 21088506, at *3 (quoting *Dietrich v. Bauer*, 76 F. Supp. 2d 312, 343 (S.D.N.Y. 1999)); *In re Ultrafem Inc. Sec. Litig.*, 91 F. Supp. 2d 678, 691-93 (S.D.N.Y. 2000) (Preska, J.) (news articles put plaintiffs on notice of potential defects with product more than one year prior to plaintiff filing claims that company failed to disclose such defects); *see also Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402, 410 (2d Cir. 1975); *Klein v. Goetzmann*, 810 F. Supp. 417, 427 (N.D.N.Y. 1993); *Westinghouse Elec. Corp.*, 821 F. Supp. at 222 ("[A] plaintiff is charged with knowledge of publicly available news articles and analysts' reports."); *see also Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1203-04 (10th Cir. 1998) (reasoning that a single *Barrons'* article "directly" discussing issues raised in plaintiffs' complaint places plaintiff on inquiry notice).

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62. Courts in fraud on the market cases look to publicly available information in finding that plaintiffs were on inquiry notice of their alleged claims. *See LC Capital*, 318 F.3d at 154-56. In any event, "an objective standard will determine whether plaintiff was on 'inquiry notice.' Thus, a plaintiff is charged with knowledge of publicly available news articles and analysts' reports." *Westinghouse Elec. Corp. v. '21' Int'l Holdings, Inc.*, 821 F. Supp. 212, 222 (S.D.N.Y. 1993) (citing *Armstrong v. McAlpin*, 699 F.2d 79, 88 (2d Cir. 1983); *In re Ames Dep't Stores, Inc. Note Litig.*, 991 F.2d 968, 977, 979 (2d Cir. 1993)).

(2) Plaintiffs Were on Inquiry Notice of Their Claims More Than One Year Before They Filed Their Claims

The Second Circuit made clear in *LC Capital* that where, as here, plaintiffs are on inquiry notice of their alleged claims but undertake no inquiry, knowledge of the alleged facts constituting such claims shall be imputed to them as of the date the duty to inquire arose. *LC Capital*, 318 F.3d at 154. Here, plaintiffs' position is that they had no duty to inquire before April 8, 2002, when the Dinallo Affidavit was filed, and they do not allege that they conducted any inquiry prior to that date.[63] Thus, the only issue in this case is the date when plaintiffs were on inquiry notice of the basic "facts" underlying their claims. *See id.* at 154; *Nairobi Holdings*, 2003 WL 21088506, at *3 (where plaintiff does not allege that it made any inquiry, "the only issue to be resolved is the date the duty to inquire arose").

Plaintiffs desperately rely on the phrase "probability of fraud" in an effort to avoid being charged with inquiry notice. (Pls. Mem. at 55-56.) Plaintiffs also take Merrill Lynch to task for describing the news articles as disclosing the "potential for the conflicts." (Pls. Mem. at 56 n. 49.)

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63. Despite their attempt to shift the burden of proving the issue of inquiry notice (Pls. Mem. at 53), it is plaintiffs who "have the burden of affirmatively pleading facts demonstrating that they have sued in a timely fashion, as timeliness is an element of the plaintiff[s'] cause of action." *Weiss v. Ganz*, 26 F. Supp. 2d 655, 658 (S.D.N.Y. 1998) (dismissing the complaint where it "fail[ed] to allege when plaintiff discovered the alleged fraud and why, in the exercise of due diligence, he could not have done so earlier").

Yet, this is the language used by the Second Circuit in *LC Capital. See* 318 F.3d at 153-54, 157 (affirming district court which found plaintiffs were on inquiry notice of *"potential* fraud" more than one year prior to commencing action) (emphasis added).

In any event, courts have found that the statute begins to run as long as plaintiffs were aware of the existence of alleged false *statements*, regardless of whether they were aware of alleged fraudulent *intent. See Addeo v. Braver*, 956 F. Supp. 443, 450-51 (S.D.N.Y. 1997) ("[T]he question is not whether the materials suggested the full extent of defendant's deceit; the question is whether the materials suggested that there were any material misrepresentations.").[64] *See also, e.g.*,

64. Indeed, the cases upon which plaintiffs rely undermine their assertion that they could not have been on inquiry notice of the details of the specific fraudulent scheme they are alleging from the media reports of possible analyst conflicts. (Pls. Mem. at 53, 55.) Plaintiffs cannot get around the well-settled law in the Second Circuit that an investor does not have to have notice of the entire alleged fraud being perpetrated or the precise details of the alleged fraud to be on inquiry notice. *See Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 351-52 (2d Cir. 1993); *see also Addeo v. Braver*, 956 F. Supp. 443, 450-51 (S.D.N.Y. 1997); *see also Salinger v. Projectavision, Inc.*, 972 F. Supp. 222, 229 (S.D.N.Y. 1997); *In re Integrated v. Res. Real Estate Ltd. P'ships Sec. Litig.*, 815 F. Supp. 620, 637 (S.D.N.Y. 1993). Moreover, courts have found inquiry notice once there is an arguable inconsistency between the published statements and the actual market conditions. *See Sedaghatpour v. DoubleClick, Inc.*, 213 F. Supp. 2d 367, 373-74 (S.D.N.Y. 2002); *In re Integrated Resources Real Estate Ltd. Partnerships Sec. Litig.*, 815 F. Supp. 620, 639 (S.D.N.Y. 1993); *Siemens Solar Indus, v. Atl. Richfield Co.*, No. 93 Civ. 1126(LAP), 1994 WL 86368, at *5 (S.D.N.Y. Mar. 16, 1994).

Fuqua v. Ernst & Young LLP, No. 01-7974, 2002 WL 535085, at *2 (2d Cir. Apr. 10, 2002) (stating that the radical decline in GFI's performance coming on the heels of rosy predictions constituted basis for inquiry notice); *Theoharous v. Fong*, 256 F.3d 1219, 1228 (11th Cir. 2001) (" 'Plaintiff need not . . . have fully discovered the nature and extent of the fraud before [he was] on notice that something may have been amiss.' ") (alterations in original) (citation omitted); *Ultrafem Inc.*, 91 F. Supp. 2d at 692 (finding inquiry notice where "the omission of [information contained in an article] in the Offering is the essence of one of plaintiffs' claims").

(3) Plaintiffs Were on Inquiry Notice of the Alleged Conflict of Interest and the Alleged Dearth of Sell Ratings

The alleged conflicts of interest and the dearth of sell ratings were issues widely debated in the financial markets and commentary long before the research reports challenged here were even issued, and the articles cited by plaintiffs in their own complaints were explicit in their discussions about them. While plaintiffs describe them as "generic statements," in fact, they are far more pointed and specific than generalized media reports. For example, the March 1999 article in *Crain's New York Business* revealed that:

> Mr. Blodget's value to Merrill Lynch is unmistakable. Internet initial public offerings have become huge moneymakers for investment banks, and firms frequently select their underwriters based upon the reputation of the analyst who covers their industry.

Appendix C

Jon Birger, *New Executive*: *Henry Blodget*, Crain's N.Y. Bus., Mar. 22, 1999, at 11 (cited in 24/7 Compl. ¶ 30; Interliant Compl. ¶ 32).[65] Moreover, despite plaintiffs' undue emphasis on defendant's role as lead underwriter in the initial public offering for 24/7 and Interliant, such information was fully disclosed to the public on the cover of the prospectus for each IPO as well as in the research reports.

(4) Plaintiffs Were on Inquiry Notice of the Allegation That Merrill Lynch Analysts Used Disparaging Language To Describe the Companies on Which They Had Positive Ratings

Mr. Blodget continued to recommend companies that he internally described as a "piece of crap," "piece of junk," or "piece of [expletive]." (24/7 Compl. ¶ 100; Interliant Compl. ¶ 100.) Plaintiffs' contention that they were not on inquiry notice of their claim because no company is specifically identified, after the bubble had burst, in the April 2, 2000 *Washington Post* article – which quotes Mr. Blodget as describing companies on which he had buy ratings as "pieces

65. *See Institutional Investor*, October 1999 ("too much conflict between banking relationship and the independent judgment necessary for hard calls;" "the concern is 'growing that the quality of research is suffering' ") (cited in 24/7 Compl. ¶ 44; Interliant Compl. ¶ 46); *Institutional Investor*, October 2000 ("[a]nalysts must bring in deals, *and there is an inherent conflict of interest there*") (cited in 24/7 Compl. ¶ 44; Interliant Compl. ¶ 46 (emphasis added)); *Industry Standard*, June 12, 2000 (cited in Original 24/7 Compl. ¶ 24; Original Interliant Compl. ¶ 25); *The Wall Street Journal*, July 14, 2000 ("absence of any sell ratings" in Blodget's ratings, Blodget as "more cheerleader than detached observer") (cited in 24/7 Compl. ¶ 52; Interliant Compl. ¶ 54.); *see also* Musoff Decl., Ex. 8.

of [expletive]" (cited in 24/7 Compl. ¶ 40; Interliant Compl. ¶ 42)–is inconsistent with their allegations. Their complaints rely heavily on Mr. Blodget's reference to other companies not at issue in this action on which he had buy ratings as a "piece of [expletive]." (*Compare* Pls. Mem. at 60; *with, e.g.*, 24/7 Compl. ¶ 100; Interliant Compl. ¶ 100.)[66] The time period of the disparagement was after the bubble had burst and after plaintiffs had lost their money.

Defendants' issuance of "BUY" ratings even in the face of substantial declines in the trading price of the stocks (24/7 Compl. ¶¶ 131-132; Interliant Compl. ¶ 127) further put plaintiffs on inquiry notice more than one year prior to the commencement of this action. *See Fuqua*, 33 Fed.Appx. at 571 ("The radical decline in performance . . . coming on the heels of rosy predictions, constituted basis for . . . inquiry [notice]."). For example, 24/7 plaintiffs allege that after the close of the class period, when defendants belatedly downgraded their ratings, stock prices had fallen more than 95% from the class period high. (24/7 Compl. ¶ 144.) "It is inconsistent for plaintiffs to argue, on the one hand, that the dramatically reversed financial data . . . shows that the

66. Moreover, it strains credulity for plaintiffs to claim here that they could not have discovered the "facts" underlying the claims before the Attorney General filed his affidavit in support of his *ex parte* motion for an injunction. The plaintiff in *re Merrill Lynch InfoSpace Analyst Reports Sec. Litig.*, No. 01-CV-6881(MP), (as well as several other plaintiffs) evidently believed that he had a basis for filing the *InfoSpace* complaint nine months prior to April 8, 2002, yet the Interliant plaintiffs, represented by the same counsel, aver that they could not have discovered their claim concerning Interliant securities—about which the Attorney General's affidavit says *nothing*—until the Attorney General filed his affidavit in April 2002.

previous statements were false and misleading, but on the other hand, that it could not have placed plaintiffs on inquiry notice of the fraud." *In re Warnaco Group. Inc. Sec. Litig.*, No. 00 Civ. 6266(LMM), 2002 WL 764980, at * 4 (S.D.N.Y. April 29, 2002); *Bibeault v. Advanced Health Corp.*, No. 97 Civ. 6026 MJL/RJW, 1999 WL 301691, *5 (S.D.N.Y. May 12, 1999).

Plaintiffs' having brought their claims more than one year after their putative class periods end is further evidence that plaintiffs' claims are untimely. *See Levine v. NL Indus., Inc.*, 926 F.2d 199, 201-02 (2d Cir. 1991). By terminating the class period on that date, plaintiffs are implicitly asserting that no putative class member was defrauded by defendants' misstatements or omissions after November 9, 2000 (24/7 plaintiffs) and February 20, 2001 (Interliant plaintiffs).

Appendix C

CONCLUSION

Apart from the other reasons set forth above which warrant dismissal of the amended pleadings, the losses of the plaintiffs during the class periods are precluded from any recovery by what has been alleged herein. The plaintiffs' holdings of the stocks after the burst of the bubble wiped out their value during the purported class periods, which precludes any recovery on their behalf herein.

The Consolidated Amended Complaints are accordingly dismissed with prejudice.

So ordered.

Dated: June 30, 2003

MILTON POLLACK
SENIOR UNITED STATES DISTRICT JUDGE

APPENDIX D — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DENYING PETITION FOR REHEARING EN BANC DATED AND FILED MARCH 31, 2005

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
THURGOOD MASHALL U.S. COURT HOUSE
40 FOLEY SQUARE
NEW YORK 10007

03-7948

Roseann B. MacKechnie
CLERK

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Thurgood Marshall United States Courthouse, Foley Square, in the City of New York, on the 31st day of March two thousand five.

John Kilgour Lentell, Brett Raynes and Juliet Raynes,

Plaintiffs-Appellants,

v

Merril Lynch & Co. Inc. and Henry M. Blodget,

Defendants-Appellees.

Appendix D

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellants John Kilgour Lentell, et al. Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is **DENIED.**

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

For the Court,
Roseann B. MacKechnie, Clerk

By: s/ [Illegible]
Motion Staff Attorney

No. 05-24

IN THE

Supreme Court of the United States

JOHN KILGOUR LENTELL,

Petitioner,

v.

MERRILL LYNCH & CO., INC. and HENRY M. BLODGET,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION FOR RESPONDENT MERRILL LYNCH & CO., INC.

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QUESTIONS PRESENTED

1. Whether this Court correctly held in *Dura Pharmaceuticals, Inc. v. Broudo*, 03-932, 125 S. Ct. 1627 (2005), that a plaintiff who asserts a fraud claim under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and who invokes a "fraud on the market" presumption of reliance, must allege sufficient facts to support a conclusion that the subject of the fraudulent statement or omission was the proximate cause of the actual loss suffered by plaintiff?

2. Whether the Due Process Clause of the Fifth Amendment requires a court of appeals that affirms the grant of a motion to dismiss to afford a losing party a second opportunity to amend his complaint, as a matter of federal constitutional mandate rather than judicial discretion?

STATEMENT PURSUANT TO RULE 29.6

Respondent Merrill Lynch & Co., Inc. has no parent corporation and no publicly held company owns 10% or more of its stock.

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I

Petitioner here asks the Court to revisit the pleading of loss causation in securities class actions – an issue it addressed only a few months ago in *Dura Pharmaceuticals, Inc. v. Broudo*, 03-932, 125 S. Ct. 1627 (2005). In *Dura*, this Court held that in a so-called "fraud on the market" case, it is necessary for a plaintiff to allege and prove a causal connection between the economic loss suffered and the defendant's misrepresentation or omission. Thus, according to this Court, an economic loss associated with a misstatement occurs "'when the facts . . . become generally known' and 'as a result' share value 'depreciates.'" *Id.* at 1633 (alteration and ellipsis in original) (quoting Restatement (Second) of Torts § 548A, cmt. b (1977)). Finding the Ninth Circuit's "inflated purchase price" standard inadequate as a matter of law, this Court held that it did not need to, and did not, "consider other proximate cause or loss-related questions." *Dura*, 125 S. Ct. at 1633-34.

In reaching its conclusion that allegations of inflated purchase price alone do not suffice to plead loss causation, the Court resolved a split in the circuit courts of appeals in favor of the legal standard articulated by the Second, Third and Eleventh Circuits and against that adopted by the Ninth Circuit. Specifically, this Court cited *Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003), as the prevailing Second Circuit standard. *See Dura*, 125 S. Ct. at 1630, 1632-33.

In the decision below, the Second Circuit held that petitioner had not adequately alleged that the revelation of the alleged omissions and misrepresentations caused his alleged losses. *See* Pet. App. 26a; *see also Dura*, 125 S. Ct. at 1634. This determination was a case-specific application of general, established legal principles that this Court adopted

in *Dura* and is consistent with decisions from other circuits on this issue. For the reasons set forth herein, the Court should deny the petition.

STATEMENT OF THE CASE

Petitioner's putative securities fraud class action is based upon the untested allegations submitted by the New York Attorney General ("NYAG") in support of obtaining a state court order to compel discovery. The state inquiry concerned the securities investment research practices of Merrill Lynch, Pierce, Fenner & Smith Incorporated, a wholly-owned subsidiary of respondent Merrill Lynch & Co., Inc. ("Merrill Lynch"). The NYAG's proceedings necessarily did not implicate the federal securities laws or, in particular, the pleading requirements of the Private Securities Litigation Reform Act of 1995 (codified in part at 15 U.S.C. § 78u-4).

In the wake of the filing by the NYAG, more than 140 private putative class actions were commenced alleging violations of the federal securities laws. Petitioner and other putative class action plaintiffs simply copied large portions of the NYAG's papers, asserting that Merrill Lynch and its internet analyst, respondent Henry Blodget, issued "false and misleading research and investment recommendations 'aimed at fraudulently driving up the market prices of [those] companies . . . and motivated by the desire to obtain and maintain investment banking business for Merrill Lynch.'" (Pet. App. 5a (alteration and ellipsis in original).) The heart of the alleged conduct concerned respondents' "Buy" and "Accumulate" ratings – which represented estimates of potential trading price appreciation in a particular security

over the ensuing twelve months and beyond. (Pet. App. 6a.)[1] These ratings remained unchanged for long periods of time; however, as the Second Circuit observed, the trading price of 24/7 Media "gyrated from $45.125 on May 12, 1999, to a high of $64.625, and to a low of $2.9375 at the close of the putative class period." (Pet. App. 8a.)[2]

Each of Merrill Lynch's research reports also carried an "investment risk rating" ranging from A (the lowest level of risk) to D (the highest level of risk). At all times, Merrill Lynch publicly disclosed its rating of the securities of the company at issue here – 24/7 Media – as "high" risk ("D"). "In addition to this systematic and consistent risk indicator," as both the Second Circuit and the district court described, "the research reports are full of (unchallenged) analysis suggesting that 24/7 Media . . . w[as] [a] volatile investment[], and therefore subject to sudden and substantial devaluation risk." (Pet. App. 29a-30a (citation omitted).)

Petitioner alleged that respondents did not believe the "Buy" and "Accumulate" ratings ascribed to 24/7 Media; that the ratings caused the securities to trade at artificially inflated

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1. The ratings criteria were publicly disclosed to the investment community and are described at length in the decisions both of the district court (Pet. App. 77a-80a) and of the court of appeals (Pet. App. 6a-7a).

2. Although the court of appeals affirmed the dismissal of two complaints, one relating to shares in Interliant, Inc. ("Interliant") and the other relating to shares in 24/7 Real Media, Inc. ("24/7 Media"), the Interliant plaintiffs have not sought review in this Court. Accordingly, references to the facts alleged and the decision of the court of appeals will be limited to those relating to the shares of 24/7 Media only.

prices; and that the trading price of 24/7 Media declined when respondents lowered their rating on the stock. (Compl. ¶¶ 140-149.) As the court below observed, however, petitioner never alleged that the market learned of the supposed falsity of the ratings during the putative class period ending on November 9, 2000. (Pet. App. 26a.) Instead, petitioner asserted that this fact was not revealed until nearly seventeen months later, when the NYAG made his allegations public in April 2002. Nor did petitioner allege that Merrill Lynch "misstated or omitted risks that did lead to the loss." (Pet. App. 26a & n.4.)

THE DECISION BELOW

The Second Circuit unanimously affirmed United States District Judge Milton Pollack's dismissal of petitioner's complaint.[3] Specifically, the Second Circuit (i) affirmed the dismissal on the ground that the complaint failed to plead loss causation, (ii) did not reach two independent bases for dismissal – failure to plead fraud with particularity and that the statements were protected by the "bespeaks caution"

3. The district court had dismissed petitioner's claims on four independent grounds: (i) for failure to plead loss causation; (ii) for failure to plead fraud with particularity; (iii) as protected by the "bespeaks caution doctrine;" and (iv) as barred by the statute of limitations. (Pet. App. 80a-126a.) Thereafter, petitioner moved the district court for reconsideration and to amend the judgment to reflect that the dismissal was without prejudice and further to permit the filing of a proposed second amended complaint. Judge Pollack denied the motion to amend on the grounds that it was both procedurally improper and that the proposed amendment was futile. (Pet. App. 55a-63a.) The district court concluded that the proposed second amended complaint, like the previous amendment, failed to plead loss causation because "[t]he proposed allegations simply do not link any of the research reports to the decline in the price of 24/7." (Pet. 61a.)

doctrine, and (iii) disagreed with Judge Pollack's conclusion that the claims were barred by the statute of limitations. The Second Circuit also held below that petitioner had not stated a claim for market manipulation pursuant to SEC Rule 10b-5(a) and (c), 17 C.F.R. § 240.10b-5(a), (c), "where the sole basis for such claims is alleged misrepresentations or omissions." (Pet. App. 31a-32a.)

Contrary to petitioner's assertions (Pet. at 12, 15), the Second Circuit in the decision below did not announce a new loss causation pleading standard. Rather, the Second Circuit applied well-established principles of loss causation to the allegations before it in addressing the specific defects in petitioner's complaint. Those principles were upheld by this Court in *Dura*.

As in *Dura*, the court below articulated that "[l]oss causation 'is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.'" (Pet. App. 21a (quoting *Emergent Capital*, 343 F.3d at 197.) Observing that the "judge-made" requirement that securities fraud plaintiffs plead loss causation was analogous to the tort-law concept of proximate cause, the court explained that in securities fraud cases, "a misstatement or omission is the 'proximate cause' of an investment loss if the risk that caused the loss was within the zone of risk *concealed* by the misrepresentations and omissions alleged by a disappointed investor." (Pet. App. 21a (citing *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 238 (2d Cir. 2000) (Winter, J., dissenting).) The court surveyed its precedents going back more than a decade to illustrate that such decisions "make clear that loss causation has to do with the relationship between the plaintiff's investment loss and the information misstated or concealed by the defendant." (Pet. App. 24a; *see also* Pet. App. 20a-25a.)

Applying these general principles to the case at hand to assess whether the petitioner sufficiently pleaded loss causation, the court below closely examined the allegations contained in the complaint. As it stated, because "[l]oss causation is a fact-based inquiry, . . . the degree of difficulty in pleading it will be affected by [the] circumstances." (Pet. App. 25a.) The court found the allegations in the complaint insufficient:

> To plead loss causation, the complaint[] must allege facts that support an inference that Merrill's misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud. As the district court found, no such allegations are made.

(Pet. App. 26a.)

In particular, because petitioner alleged that the decline in 24/7 Media's stock price occurred concurrently with the downgrade of the recommendation on the stock, the court considered whether petitioner had alleged a causal connection between the subject of the allegedly fraudulent statement and the loss actually suffered, concluding that the downgrade was not a corrective disclosure. (Pet. App. 26a & n.4 (plaintiff's allegation that Merrill's eventual downgrading of 24/7 Media "negatively impacted the price of those securities" did "not amount to a corrective disclosure, however, because [it did] not reveal to the market the falsity of the prior recommendations"); *see also* Pet App. 28a ("The only misrepresentation that can inhere to the 'buy' and 'accumulate' recommendations is that they were not Merrill's true and sincere opinion.").)

The court also explained that petitioner did "not challenge the detailed financial information and investment analysis published alongside Merrill's fraudulent recommendations." (Pet. App. 28a.) Thus, petitioner's complaint was "sharply distinguishable" from earlier cases in which plaintiffs had alleged that the defendants had "'doctored' or hid" a risk that materialized, causing their losses. (Pet. App. 31a; *cf.* Pet. at 13-15 (asserting that his complaints would have survived under *Suez Equity Investors* and *Emergent Capital*).)

Instead, the court below concluded that "substantial indicia of the risk that materialized are unambiguously apparent on the face of the disclosures alleged to conceal the very same risk." (Pet. App. 31a.) Indeed, it was "incontestible that the risk of price volatility – and hence, the risk of implosion – is apparent on the face of every report challenged in the underlying complaints." (Pet. App. 28a-29a.) As petitioner had failed to plead any "facts to establish that the Firm's misstatements . . . concealed the price-volatility risk (or some other risk) that materialized and played some part in diminishing the market value of 24/7 Media," petitioner failed to plead loss causation. (Pet. App. 30a.)

The court below also rejected *sub silentio* petitioner's contentions that he should be permitted to amend to meet what he characterized – erroneously – as "the newly raised standard" for pleading loss causation because his proposed second amended complaint could satisfy the circuit's loss causation pleading standards. (Appellants' Br. at 78-79.)

Petitioner then sought panel rehearing and rehearing *en banc* asserting, as he does here, that the decision below raised the Second Circuit's loss causation pleading standards.

Petitioner did not, however, maintain, as he does here, that it would be a denial of due process for the court to deny him another opportunity to amend his complaint. The petition for rehearing and panel rehearing was denied, with no active judge voting in favor of a rehearing *en banc*. (Pet. App. 128a.)

REASONS FOR DENYING THE PETITION

1. The Decision Below was Correctly Decided and is Consistent with Both This Court's *Dura* Decision and the Purposes of the Private Securities Litigation Reform Act of 1995

Earlier this year, this Court decided *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005), to resolve a split in the circuits on what is required to establish loss causation in a securities fraud claim under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), where, as is the case here, plaintiff invokes the so-called "fraud on the market" presumption of reliance. This Court in *Dura* specifically addressed the question of whether it is sufficient for purposes of pleading loss causation to allege that "'the price *on the date of purchase* was inflated because of the misrepresentation.'" 125 S. Ct. at 1630 (citation omitted; emphasis in original). Recognizing the validity of the view of the Second Circuit, among other circuits, this Court held that "as a matter of pure logic" there cannot be a loss at the time of purchase because the artificial inflation created by the alleged misrepresentation "is offset by ownership of a share that *at that instant* possesses equivalent value." *Id.* at 1631. This Court explained that "a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains 'when the facts . . .

become generally known' and 'as a result' share value 'depreciate[s].'" *Id.* at 1633 (alteration and ellipsis in original) (quoting the Restatement (Second) of Torts § 548A, cmt. b (1977)). Indeed, this Court further clarified that even after the misrepresentation has been revealed to the market, there may not be a loss attributable to it:

> [The] lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price. . . . Other things being equal, the longer the time between purchase and sale . . . the more likely that other factors caused the loss.

Dura, 125 S. Ct. at 1632.

Rejecting the Ninth Circuit's inflated purchase price approach and siding with the standards applied by the Second, Third and Eleventh Circuits, this Court emphasized that its holding was consistent with an important objective of the federal securities laws – that private rights of action under the anti-fraud provisions of the securities laws be "available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." *Dura*, 125 S. Ct. at 1633.

> Given the common-law roots of the securities fraud action (and the common-law requirement that a plaintiff show actual damages), it is not surprising that other courts of appeals have

> rejected the Ninth Circuit's "inflated purchase price" approach to proving causation and loss.

Id. at 1632-33 (citing *Emergent Capital*, 343 F.3d at 198; *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997); *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990)). Following the common law, "[t]he [Private Securities Litigation Reform Act of 1995] makes clear Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss." *Dura*, 125 S. Ct. at 1633.

The Second Circuit's decision below, which relied on its prior precedent in *Emergent Capital*, 343 F.3d 189, is entirely consistent with this Court's decision in *Dura* and was correctly decided. The decision below simply articulated and applied general, well-settled legal principles of loss causation that were upheld by this Court in *Dura*, requiring a plaintiff to allege a connection between the subject of the allegedly fraudulent statement and an actual economic loss. (Pet. App. 21a-22a; *see also Dura*, 125 S. Ct. at 1632-33.)

Petitioner's allegations and theories of loss causation have shifted throughout this litigation and have properly been rejected at every turn. In his complaint, petitioner asserted two possible theories of loss causation: first, that respondents' "buy" and "accumulate" ratings caused the securities to trade at artificially inflated prices at the time of purchase, and second, that the trading price of the securities declined when respondents lowered their ratings on the stock. The court below – consistent with the Court in *Dura* – properly and

squarely rejected petitioner's "inflated purchase price" allegations as insufficient to establish loss causation.

> Plaintiffs . . . allege that Merrill's "material misrepresentations and omissions induced a disparity between the transaction price and the true 'investment quality'" of 24/7 Media . . . securities; "that the market price of [the] securities was artificially inflated; and that the securities were acquired "at artificially inflated prices and [the plaintiffs] were damaged thereby." Assuming (as we must) the truth of these allegations, they may establish transaction causation; but they do not provide the necessary causal link between Merrill's fraud and plaintiffs' losses.

(Pet. App. at 27a (alterations in original) (citing *Emergent Capital*, 343 F.3d at 198).) *See also Dura*, 125 S. Ct. at 1631 ("as a matter of pure logic" there cannot be a loss at the time of purchase).[4]

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4. In the court of appeals, petitioner amplified this theory of loss causation he alleged in the complaint by asserting that "Defendants' fraud resulted in artificially inflated stock prices, and . . . the market correction of these inflated prices led Plaintiffs to suffer damages." (Appellants' Br. at 47.) This theory, however, did not differ in any meaningful way from the earlier one ultimately rejected by this Court in *Dura*, *see* 125 S. Ct. at 1629, adding only an allegation that the inflation was no longer incorporated into the price of the securities by the end of the putative class period because, somehow, it was eliminated "through the normal operation of the forces of supply and demand." (Pet. at 21.) This empty allegation – which fails to connect any misrepresentation with an identified economic loss – is in fact one of the vestiges of the now overruled Ninth Circuit pleading standard. *See Wool v. Tandem Computers*,

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With respect to the second alleged theory contained in the complaint, the court below concluded that the alleged loss could not have been caused by respondents' downgrading of the stock ratings because the downgrading, by itself, "do[es] not reveal to the market the falsity of prior recommendations." (Pet. App. 26a n.4.) In fact, petitioner never alleged that the market learned of the alleged falsity of the investment opinions during the putative class period ending in November 2000. The court below observed that, "[t]o the contrary, plaintiffs have argued affirmatively on this appeal that the falsity of Merrill's recommendations was made public no earlier than April 2002. . . . The complaints withstand the statute of limitations on the strength of that argument." (*Id.*) Accordingly, the court explained that the complaint could not plead a causal connection between the alleged misrepresentation and the asserted loss: "Merrill's concealed opinions regarding 24/7 Media . . . could not have caused a decrease in the value of [the stock] before the concealment was made public." (*Id.*)

In his Petition to this Court, petitioner again shifts legal theories. No longer fettered by the district court's statute of limitations dismissal in light of the decision below on this point, petitioner now asserts before this Court – contrary to

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Inc., 818 F.2d 1433, 1437 (9th Cir. 1987) (hypothesizing that "the increment of artificial inflation caused by misrepresentations may fluctuate 'as a result of market forces operating on the misrepresentations'" and therefore, so-called "in and out" traders may recover in an action for securities fraud) (*cited in* Appellants' Br. at 57). Petitioner expressly relied upon *Wool* below, and now, in light of *Dura*'s overruling of the Ninth Circuit's loss causation jurisprudence, relies on equally dubious, pre-*Dura* rulings of district courts for his same theory of loss causation.

his complaint – that, indeed, the market did learn of the alleged falsity of the ratings at some indeterminate time during the putative class period. (*See* Pet. at 3 ("the market gradually realized").) He thus now maintains that his economic loss was occasioned by the decline in share price caused when the alleged falsity of Merrill Lynch's opinions was revealed to the market at unspecified and indeterminate times. (*See* Pet. at 21.) But below, petitioner repeatedly argued – successfully to the Second Circuit in order to prevail on the statute of limitations argument – that the falsity of the opinions was not revealed until the NYAG made his allegations public on April 8, 2002, long after the end of the putative class period. (*See* Pet. App. 26a n.4; *see also* Appellants' Br. at 25, 30, 34; Appellants' Reply Br. at 3.) Not only does petitioner's new theory fail under *Dura* because it does not plead a connection between a misrepresentation and an actual economic loss, but the Court need not decide issues that were not presented or decided below. *See, e.g.*, *Davis v. United States*, 495 U.S. 472, 489 (1990).

The Second Circuit correctly held that, on the facts alleged, petitioner failed to plead either a connection between any of the more than 40 allegedly false "buy" or "accumulate" ratings and the decline in the trading price of 24/7 Media securities, or that the research reports concealed any risk that materialized and thereby caused petitioner's losses. (Pet. App. 26a & n.4.)

> The only misrepresentation that can inhere to the "buy" and "accumulate" recommendations is that they were not Merrill's true and sincere opinion. Yet plaintiffs allege no loss resulting from the market's realization that the opinions were false, or that Merrill concealed any risk that could

> plausibly (let alone foreseeably) have caused plaintiffs' loss.

(Pet. App. 28a.) This fact-specific application of general principles of loss causation and proximate cause to the complaint at issue in this case does not merit review by this Court.

2. There is No Conflict Among the Circuits on the Question Presented

The decision below is consistent with fundamental principles of loss causation articulated in longstanding Second Circuit precedent, as well in the Third, Seventh and Eleventh Circuits, all of which were upheld by this Court in *Dura*. *See Dura*, 125 S. Ct. at 1632-33 (citing *Emergent Capital*, 343 F.3d at 198; *Semerenko*, 223 F.3d at 185; *Robbins*, 116 F.3d at 1448; *Bastian*, 892 F.2d at 685); *see also* Pet. App. 27a (citing *Emergent Capital*, 343 F.3d at 198). None of the court of appeals decisions which petitioner asserts have articulated "different standards" for pleading loss causation in securities fraud cases (Pet. at 12-20) has held, as petitioner asserts, that a plaintiff's alleged economic loss could be held to have been proximately caused by a misstatement or omission before the subject matter of the misstatement or omission was disclosed to the public. To the contrary, the plaintiffs in the circuit court cases relied upon by petitioner cited "explicit disclosures" in support of their loss causation allegations – precisely what petitioner asserts he is *not* required to plead in order to sufficiently allege loss causation.

More fundamentally, petitioner does not – and cannot – set forth a crisp statement of the nature of the alleged circuit

conflict. In fact, none of the circuit decisions cited by petitioner even addressed petitioner's current or former theory of loss causation. (*See* Pet. at 13-20.) Nor were any of these decisions of other circuits decided after *Dura*. Therefore, there is no reason for the Court to revisit the issue of loss causation pleading at this point absent further percolation of the issue in the courts of appeals.

Petitioner premises the asserted conflict on an incorrect statement of the decision below which he couples with his mere speculation that his complaint would have survived a motion to dismiss under other circuits' pleading standards *because it is not necessarily "foreclose[d]"* by those decisions or by this Court's decision in *Dura*, 125 S. Ct. 1627. (Pet. at 21; *see also id.* at 19-20.) All of the other circuit court decisions and *Dura* are consistent, however, with the holding below that a plaintiff may plead loss causation by alleging "'that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered,' *i.e.*, that the misstatement or omission concealed something from the market that, when disclosed negatively affected the value of the security." (Pet. App. 21a-22a (quoting *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001)).)

> To plead loss causation, the complaints must allege facts that support an inference that Merrill's misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud. As the district court found, no such allegations are made. There is no allegation that the market reacted negatively to a corrective

> disclosure regarding the falsity of Merrill's "buy" and "accumulate" recommendations and no allegation that Merrill misstated or omitted risks that did lead to the loss. This is fatal under Second Circuit precedent.

(Pet. App. 26a (citation omitted).)

The court below articulated a general standard in explaining why petitioner's complaint was fatally defective:

> The only misrepresentation that can inhere to the "buy" and "accumulate" recommendations is that they were not Merrill's true and sincere opinion. Yet plaintiffs allege no loss resulting from the market's realization that the opinions were false, or that Merrill concealed any risk that could plausibly (let alone foreseeably) have caused plaintiffs' loss.

(Pet. App. 28a.) That standard is consistent with *Dura* and the other circuit court decisions.

In fact, in each of the other circuit court cases, plaintiffs had asserted that their losses occurred following public announcements that allegedly revealed the subject of the nondisclosures; the courts then examined whether it was the revelation of the alleged misrepresentation or omission that was the actual cause of the decline in the stock price. *See Semerenko v. Cendant Corp.*, 223 F.3d 165, 169-71, 183-87 (3d Cir. 2000) (decline in share price following public announcements of accounting irregularities and termination of merger agreement); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1445-49 (11th Cir. 1997) (complaint dismissed

where, although the share price declined following a dividend announcement, the announcement did not reveal the alleged misrepresentation).[5]

Petitioner also asserts, albeit indirectly, that the Second Circuit held that petitioner was "precluded" from pleading that his alleged losses were caused by Merrill Lynch's research recommendations because the "intervening decline in Internet stock prices" broke the chain of causation. (*See* Pet. at 19, 20.) This supposed conflict is also predicated on a misstatement of the holding below and likewise finds no support in any of the circuit decisions upon which petitioner relies. The decision below concluded that the "risk of price volatility and hence the risk of implosion" – the risk that materialized – was "incontestibl[y]" disclosed. Applying ten-year-old precedent, the court below held that in the face of the bursting of the technology bubble (of which the court took judicial notice), petitioner was required, but failed, to allege facts sufficient to support the inference that the asserted losses were caused by the misstatements and omissions alleged in the complaint and not the general decline in the market. (Pet. App. 28a-31a; *see also Powers v. British Vita, P.L.C.*, 57 F.3d 176, 189-90 (2d Cir. 1995) (affirming dismissal in light of failure to sufficiently allege loss causation due to "presence of a . . . direct intervening cause" of loss); *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 771-72 (2d Cir. 1994) (affirming dismissal where plaintiffs failed to allege a factual basis to support

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5. Petitioner does not actually rely upon any decision by the court of appeals for the Seventh Circuit as the basis for his asserted conflict. Instead, he relies on a six-year old "recent" district court opinion that he describes as "the Seventh Circuit standard." (Pet. at 17-18.)

their causation claim following the collapse of the real estate market).) The court observed:

> "[W]hen the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases," and a plaintiff's claim fails when "it has not adequately ple[ ]d facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events."

(Pet. App. 25a (second alteration in original) (quoting *First Nationwide Bank*, 27 F.3d at 772).) Indeed, as this Court recognized in *Dura*, even after a misrepresentation is revealed to the market:

> [A] lower [trading] price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price. . . . Other things being equal, the longer the time between the purchase and sale, the more likely that is so, *i.e.*, the more likely that other factors caused the loss.

Dura, 125 S. Ct. at 1632.[6]

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6. The Eleventh Circuit in *Robbins* noted in passing – in a case which did not involve the collapse of a market – that a plaintiff need not show that the defendant's misrepresentation was responsible for

(Cont'd)

The Second Circuit's conclusion here is not in conflict with the pre-*Dura* circuit decisions cited by petitioner, let alone any post-*Dura* decisions. The Petition should be denied because petitioner's reliance on a pre-*Dura* alleged circuit conflict (which does not exist) or on a purported conflict between district court decisions does not raise an issue worthy of this Court's review.

3. The Due Process Clause of the Fifth Amendment Is Not Implicated by the Second Circuit's Affirmance of a Refusal to Permit Petitioner to Amend a Second Time

There are no constitutional implications that flow from the Second Circuit's affirmance of a grant of a motion to dismiss without leave to amend. Any other conclusion would open the floodgates to constitutional due process challenges any time a court of appeals affirms a dismissal with prejudice. Petitioner's contention that his due process rights were violated because he was not given leave to amend fails both because federal constitutional due process principles do not protect rights that are discretionary and because the decision below did not establish a new, higher pleading standard, as petitioner maintains.

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the *entire* decline. *See Robbins*, 116 F.3d at 1447 n.5. The Third Circuit in *Semerenko* ruled that an intervening tender offer, which drove the allegedly inflated share price to rise to the bid price was not "sufficient to break the chain of causation." *Semerenko*, 223 F.3d at 186-87. The Second Circuit's holding that a plaintiff must allege sufficient facts to support an inference that his losses – or some portion of them – resulted from an alleged nondisclosure rather than from the market collapse thus does not conflict with either *Robbins* or *Semerenko*. (*See* Pet. App. 31a.)

The Due Process Clause of the Fifth Amendment does not protect discretionary entitlements. *See Town of Castle Rock v. Gonzales*, 125 S. Ct. 2796, 2803 (2005) ("Our cases recognize that a benefit is not a protected entitlement if government officials may grant or deny it in their discretion."); *see also Board of Regents of State Colleges v. Roth*, 408 U.S. 564, 577-78 (1972). It is "[o]nly after finding the deprivation of a protected interest [that the Court looks] to see if the State's procedures comport with due process." *American Mfrs. Mut. Ins. Co. v. Sullivan*, 526 U.S. 40, 59 (1999). Whether a court will permit further amendment of a pleading following a previous amendment is a matter of discretion. *See, e.g., Conboy v. AT&T Corp.*, 241 F.3d 242, 259 (2d Cir. 2001); *see also* Fed. R. Civ. P. 15(a). Therefore, petitioner's right to amend his complaint is not a right protected by the Due Process Clause, and any inquiry into the procedures used to deny further amendment is unnecessary.

Furthermore, the predicate of petitioner's supposed due process claim (Pet. at 25-26) – that the Second Circuit raised the pleading standards without affording him an opportunity to amend – is wrong. The decision below does *not* hold that any and all securities fraud plaintiffs "must allege 'facts sufficient to support an inference that it was defendant's fraud – rather than other salient facts – that proximately caused plaintiff's loss or . . . to apportion the losses between the disclosed and concealed portions of the risk that ultimately destroyed the investment.'" (Pet. at 26 (ellipsis in original) (quoting Pet. App. 31a).) Petitioner has omitted a critical limitation from his statement of the holding below: *immediately preceding* the language quoted by petitioner, the Second Circuit *limited* its holding to situations "where (as here) substantial indicia of the risk that materialized are

unambiguously apparent on the face of the disclosures alleged to conceal the very same risk." (Pet App. 31a (emphasis added).)

This qualified holding was plainly dictated by petitioner's own factual allegations. The court of appeals explained that petitioner's failure to allege that respondents "doctored" or concealed information relating to material risks associated with an investment in 24/7 Media made petitioner's case "sharply distinguishable from cases in which some or all of the risk that materialized was clearly concealed by a defendant's misstatements or omissions." (Pet. App. 31a (citing *Suez Equity*, 250 F.3d at 97-98 and *Emergent Capital*, 343 F.3d at 196-98); *cf.* Pet. 14-15 (asserting that his proposed amended complaint would have been sustained under *Suez Equity* and *Emergent Capital*).)

In addition to petitioner's misstatement of the ruling below, no judge on the panel below dissented from the opinion on the ground that a legal standard had been altered or raised without notice, as occurred in the cases upon which petitioner relies.[7] Nor did any active judge vote in favor of

7. *See* Pet. at 25-26 (citing *Sun-Land Nurseries, Inc. v. So. Cal. Dist. Council of Laborers*, 793 F.2d 1110, 1121 (9th Cir. 1986) (*en banc*) (Wiggins, J., dissenting) ("granting a dismissal on the pleadings without leave to amend based on a new legal standard. . . ."); *Brown v. Coach Stores, Inc.*, 163 F.3d 706, 714 (2d Cir. 1998) (Newman, J., dissenting) (asserting that the court applied a new standard to plaintiff's employment discrimination claim); and *Hatch v. Federal Energy Regulatory Comm'n*, 654 F.2d 825, 834-37 (D.C. Cir. 1981) (alteration of the standard of proof imposed by the government in an adjudicatory administrative proceeding in which one commissioner dissented on grounds that the commission had changed the standard of proof)). None of these cases holds that it was a denial of due process not to provide the party with notice of the legal standard to be applied in each of the proceedings.

rehearing *en banc*. (Pet. App. 128a.) Instead, in rendering its unanimous decision below, the court discussed at length and expressly relied upon the circuit's prior precedents (Pet. App. 20a-25a), explaining that "[t]his Court's cases – post-*Suez* and pre-*Suez* – require both that the loss be foreseeable and that the loss by caused by the materialization of the concealed risk." (Pet. App. 22a (citations omitted).) "We follow the holdings of *Emergent Capital*, [343 F.3d 189], *Castellano* [*v. Young & Rubicam, Inc.*, 257 F.3d 171 (2d Cir. 2001)], and *Suez Equity*, [250 F.3d 87]." (Pet. App. 24a.)

Furthermore, petitioner plainly *was* on notice of the requirement that he plead that respondents concealed a risk that materialized and, thereby, caused his losses, but he apparently was unable to do so. As the court below noted:

> [Petitioner] alleged that plaintiffs were injured "because the risks that materialized were risks of which they were unaware as a result of Defendants' scheme to defraud," and that they would not have been injured absent the scheme. But that is a legal conclusion; missing are the necessary allegations of fact to support the conclusion.

(Pet. App. 28a.)

Petitioner asks the Court to fashion a rule that is without guideposts, is unworkable in practice and, therefore, lacks any broad applicability. Any losing party who disagreed with the way the law was applied on the facts of his case might assert that his due process rights were violated because the court did not permit him to amend his complaint to meet the "new" standard. Such a rule is unsupported.

The Second Circuit's conclusion here is not in conflict with the pre-*Dura* circuit decisions cited by petitioner, let alone any post-*Dura* decisions. The Petition should be denied because petitioner's reliance on a pre-*Dura* alleged circuit conflict (which does not exist) or on a purported conflict between district court decisions does not raise an issue worthy of this Court's review.

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> [Petitioner] alleged that plaintiffs were injured "because the risks that materialized were risks of which they were unaware as a result of Defendants' scheme to defraud," and that they would not have been injured absent the scheme. But that is a legal conclusion; missing are the necessary allegations of fact to support the conclusion.

(Pet. App. 28a.)

Petitioner asks the Court to fashion a rule that is without guideposts, is unworkable in practice and, therefore, lacks any broad applicability. Any losing party who disagreed with the way the law was applied on the facts of his case might assert that his due process rights were violated because the court did not permit him to amend his complaint to meet the "new" standard. Such a rule is unsupported.